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The Thin Corporate Line: Loss of Limited Liability Protection

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THE THIN CORPORATE LINE: LOSS OF LIMITED LIABILITY PROTECTION

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Business and popular mythology and corporate jurisprudence generally accept unquestioningly the concepts of the limited liability of the investor-shareholder and the discrete personality of the corporate form. An inseparable interdependence is supposed between the two concepts. Pedantically and occasionally tartly discussed and criticized in legal and economic journals,[1] these two assumptions are immensely helpful to the business lawyer in explaining the advantages of incorporation to his client, to the law teacher in distinguishing business forms and legal principles and consequences, and the court in selecting its law and determing the results in a given case. But these concepts are in fact relative and subject to legal fissures. Theoretical and metaphysical arguments concerning the concepts aside for the moment one must remember the reality of the judicial hammer variously known as "piercing" the corporation veil, disregarding corporateness, or pushing away the entity web which seems to negate the perfection and consistency elsewhere accorded the two concepts.

In a decade notable for its lack of symmetry and swirls of change it may seem unsurprising that the symbiosis of those two concepts is being frequently judicially disrupted. But the changes cannot be traced to this epoch. Pure judicial inventiveness in the area of corporate law is no novelty-witness the application of the "de facto" doctrine to corporations, their officers, and fusions, the stockholder's derivative suit, the fiduciary principles governing the actions of management and majority or dominant stockholders, the recognition of the stockholder's preemptive rights and right to inspect corporate books, and the private remedy granted shareholders for violations of the federal securities laws. Like these doctrines, judicial willingness to deny limited liability to shareholders antedates this decade and by over a century. In *Bank of the United States v. Deveaux*,[2] Chief Justice Marshall dealt with the question

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1. *Compare* Deiser, *The Juristic Person*, U. PA. L. REV. 131 (1908) *with* Kessler *with Limited Liability For All: Why Not A Partnership Corporation*, 36 FORDHAM L. REV. 235 (1967).

2. 9 U.S. (5 Cranch) 61 (1809). *Compare* Osborn v. Bank of the United States, 22 U.S. (9 Wheaton) 737, 765-68 (1824).

whether a corporation constituted a citizen. The Supreme Court declared:

> [T]hat invisible, intangible, and artificial being, that mere legal entity, a corporation aggregate, is certainly not a citizen; and consequently, cannot sue or be sued in the courts of the United States, unless the rights of the members, in this respect, can be exercised in their corporate name.[3]

Noting this country's concept of the corporation "derived entirely from the English Books" the Court approved earlier English precedent stating:

> In that case, the objection, that a corporation was an invisible, intangible . . . mere incorporeal legal entity, in which the characters of the individuals who composed it were completely merged . . . was considered. The judges unanimously declared . . . they could look beyond the corporate name, and notice the character of the individual. . . . It appears to the court, to be a full authority for the case now under consideration.[4]

This article will endeavor from several perspectives to view corporate investor liability under the "piercing" doctrine. The historical background of the doctrine will be outlined, its various formulations and criteria analyzed, and the effect of the type of corporation involved and the nature of the claimant on the application of the doctrine will be reviewed. An effort will be made to ascertain whether new or modified legal tests ought to be devised and whether the state legislatures should be encouraged to intervene to deal with the problems giving rise to the doctrine of disregarding corporateness.

Before tackling these matters some general observations about the doctrine of disregarding the corporate entity seem in order. First, knowledge of the doctrine's existence is not particularly helpful in assuring the investor's goal of limited liability in entering the corporate enterprise. This is so because of the imprecision of its various formulations and the inability to predict with reasonable certainty the moment or circumstances of its availability. This inherent difficultly is illustrated by the famous dictum of a federal district court in 1905:

> If any general rule can be laid down, . . . it is that a corporation will be looked upon as a legal entity as a general

3. Bank of the United States v. Deveax, 9 U.S. (5 Cranch) 61, 85 (1809).
4. *Id.* at 89.

> rule, and until sufficient reason to the contrary appears; but, when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons.[5]

This statement cannot be much improved upon or clarified today.[6] The equitable nature of the doctrine of disregarding corporateness demands flexibility and adaptability which inevitably leads to confusion in stating and applying the doctrine.[7] Second, the doctrine itself is sometimes hard to reconcile with repeated judicial declarations that incorporation for the purpose of attaining limited liability is unassailable and with the generally unexcepted grant of limited liability by the legislature to the investors of a properly incorporated business. Third, the loosely stated principle is applied equally to the single close or public corporation and to parent-subsidiary and affiliate relationships. A consequence is that the same tests under the principle in some instances will be applied to different types of corporations and relationships. While some overlapping of substantive law is to be expected because the objective of the plaintiff is the same in all such cases, it is also true courts should be more attentive to the different natures, modes of operations, purposes, and resources of each type of corporation in framing standards and assessing the justice of a particular result. Fourth, as a concomitant to treating different corporate structures differently under the doctrine, account must be taken of the nature of the wrong, be it a delict or contractual, and the nature of the claimant, whether an individual or entity. Fifth, it must be remembered the principle may be applied at the time of formal incorporation or at any other point thereafter during corporate life. Indeed the longevity of the corporate enterprise involved usually affords the investor no greater

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5. United States v. Milwaukee Refrigerator Transit Co., 142 F. 247, 255 (Cir., E.D. Wis. 1905).

6. *See* Comment, *Liability of a Corporation for Acts of a Subsidiary or Affiliate*, 71 HARV. L. REV. 1122 (1958) which laments the consistent failure of courts to state specific ratiocination in applying the "piercing" doctrine. Fletcher is equally unhelpfll stating: "If any general rule can be laid down, in the present state of authority, it is that a corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but, when the notion of legal entity is used to defeat public convenience . . . the law will regard the corporation as an association of persons." 1 W. FLETCHER, CYCLOPEDIA CORPORATIONS § 41, 167-168 (rev. ed. 1963). Nor do the standard corporate law hornbooks offer completely reliable grounds to guide the practitioner. H. BALLANTINE, CORPORATIONS, ch. X (rev. ed. 1946); H. HENN, CORPORATIONS, ch. 7 (1961); G. HORNSTEIN, CORPORATION LAW AND PRACTICE ch. 30 (1959); N. LATTIN, LATTIN ON CORPORATIONS ch. 2 (1959); R. STEVENS, STEVENS ON CORPORATIONS ch. 3, 20 (2d ed. 1949). In the case of close corporations, which are perhaps most susceptible to the "piercing" doctrine, the leading treatise does not offer certitude and predictability as to when personal liability will be imposed. 1 F. O'NEAL, CLOSE CORPORATIONS § 1.10 (1958).

7. 1. W. FLETCHER, *supra* note 6 at § 41.2, 177-78 states:

> Most of the cases announcing this rule for disregarding the corporate entity have been in equity or equitable in nature, the doctrine being one of equity, but there is authority that the law will follow equity in this regard, atlhough in one view that may be questioned. (citations omitted).

protection from liability than does the fact he may have just recently purchased his stock.

Those forming, investing in, and managing a corporation, whatever its nature, would do well to remember their shield of limited liability is vulnerable to judicial attacks, even though their business behavior may be deemed conventional and non-deceptive. Thus, as this article tries to intimate, two matters should be of overriding concern to investors in avoiding this doctrine: (a) responsible management and control of the business and (b) corporate resources adequate for the risks reasonably anticipated in the corporation's foreseeable, normal operations, both of which presuppose perhaps more careful business planning and projecting than may ordinarily be given to the creation of close corporations.

I. CONCEPT AND ORIGIN OF CORPORATENESS: HISTORICAL PERSPECTIVE

Modern law school casebooks on corporation law do not give elaborate treatment to the doctrine of disregarding corporateness or the arcane history of the entity theory and limited liability.[8] As a practical matter this reflects the popular view that the incorporation process has long given rise to what are thought of as two harmonious, essential characteristics, namely, that the corporation is a separate jural person (fictitious entity) and limited liability is always granted shareholders. Rarely are those alleged attributes of corporateness challenged except in limited instances such as "piercing" the corporate veil. Corporate treatises, casebooks, cases, and practice have generally approved as accepted legal dogma the "fiction" theory which views the corporation as a separate entity.[9] This entity theory has been judicially linked to the notion of limited liability in the well known *Benintendi* case:

8. R. BAKER and W. CARY, CORPORATIONS: CASES AND MATERIALS 374-402 (3rd ed. unabr. 1959); A. FREY, C. MORRIS, and J. CHOPER, CASES AND MATERIALS ON CORPORATIONS 53-81 (1966); N. LATTIN, R. JENNINGS, and R. BUXBAUM, CORPORATIONS: CASES AND MATERIALS 136-82 (1968); R. STEVENS and H. HENN, STATUTES, CASES, AND MATERIALS ON THE LAW OF CORPORATIONS 362-400 (1965). The new supplement to the Baker and Cary Casebook reinforces this impression. W. CARY, CORPORATIONS: CASES AND MATERIALS 230-53 (Supp. 1968). D. HERWITZ, CASES AND MATERIALS ON BUSINESS PLANNING 52-60, 98-114 (temporary ed. Part 1 1963) does not deal directly with these concepts but discusses the related problem of corporate financial management in terms of distinguishing between debts and equity interests and adequate capitalization. Book reviews of current corporate law casebooks evince little concern over the treatment given the "piercing" doctrine. *e.g.*, Marsh, Book Review, J. LEGAL ED. 250 (1968); Myers, Book Review, J. LEGAL ED. 232, 235 (1966): ("The authors overwork less important subject matter. Considerable material was used in developing the nature of corporateness.").

9. There is of course dissent from the position corporations are "entities created by government fiat." A. BERLE, STUDIES IN THE LAW OF CORPORATION FINANCE 20 (1928) states:

> [I]t is perhaps plain that a corporation was originally a matter of agreement; that it remained so when share capital was introduced; and that for practical purposes under the liberal corporation laws of today it is still so.

Berle does support the privilege of limited shareholder liability, *id.* ch. IV. Confusion may be generated by using the phrases entity theory, concession theory, and *persona ficta* interchangeably to describe the corporation. Berle rejects the concession theory which viewed the corporation as a legislative creature subject to the sovereign's dictates in favor of a theory permitting maximum private structuring of the business.

> The state, granting to individuals the privilege of limiting their individual liabilities for business debts by forming . . . an entity separate and distinct from the persons who own it, demand in turn that the entity take a prescribed form and conduct itself . . . according to fixed rules. . . .[10]

From a legal position defenders of the "fiction" theory acknowledge trouble. Machen has stated:

> [A]lthough corporate personality is a fiction, the entity which is personified is no fiction. The union of members is no fiction. The acting as if they were one person is no mere metaphor. . . . [A]lthough corporate personality is a fiction, yet it is a fiction founded upon fact . . . . To argue that because the personality of a corporation is a product of the imagination, therefore the corporation itself, as anything different from the separate members, is a fiction would be as reasonable as to argue that because a ship is not really a female, and is personified only by way of metaphor, therefore it has no real existence except as a number of boards and nails.[11]

Yet Machen is not unaware that "the temptation to apply the doctrine of corporate personality too sparingly is much less insidious than the temptation to apply it too freely."[12] As an adherent to the faith of the corporate fiction he recognizes its limitations in corporate problem solving and its frequent irrelevance in evaluating the merits or wisdom of a proposed rule of corporate law. The conventional wisdom of the separate entity fiction theory has been seriously questioned. John Dewey, writing as a layman, regards it as "ultimately a philosophical theory that the corporate body is but a name, a thing of the intellect."[13] Dewing states it as "historically inaccurate and contrary to empirical observation" to hold that the corporation "exists independently of the human needs which fostered its development."[14] Rejecting a status of "sanctified self-sufficiency" for the corporation form he opts for a theory under which the corporation is

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10. *Benintendi v. Kenton Hotel, Inc.*, 294 N.Y. 112, 118, 60 N.E.2d 829, 831 (1945). The rationale of the case was subsequently overruled by changes wrought by the 1963 New York Business Corporation Law.

11. Machen, CORPORATE PERSONALITY, 24 HARV. L. REV. 253, 266, 347, (1911). He remarks: "Therefore, what needs explanation in the common law is not the doctrine that a corporation is an entity, but the doctrine that a partnership or other voluntary association is not an entity." *Id.* at 260.

12. *Id.* at 356.

13. Dewey, *The Historic Background of Corporate Legal Personality*, 35 YALE L. J. 655, 677 (1926). He suggests ignoring the idea of a separate personality "until the concrete facts and relations involved" are confronted. *Id.* at 673.

14. 1 A. DEWING, FINANCIAL POLICY OF CORPORATIONS 18 n.t. (5th ed. 1953). This note also contains a remarkably concise description of the opinions of continental scholars regarding the nature of the corporation.

> [A] fiction of human ingenuity . . . without the attribute of reality, except to the extent that it acquires a reflected reality from the human beings who . . . bring about its conception and maintain its existence. The corporation is a name only; and the name denotes the common purpose . . . of human beings. The state recognizes this purpose and treats it as distinct from the human beings who jointly conceived it. . . . [N]either the state nor the members . . . endow it with reality.[15]

More recently Professor Hornstein noting the inadequacy of the *persona ficta* concept to describe the corporate form lists the *realist, symbol* and *enterprise entity* theories as possible alternatives or substitutes.[16] The need to advance other theories strongly hints at the limitations, if not the virtual bankruptcy, of the "fiction" theory in terms of its overall relevance in deciding issues of corporate law. As Dewing has observed of the debate about the nature of the corporation:

> As an intellectual antinomy it is now no nearer a final solution than when Parmenides, son of Peres, walked the byways of Velia.
>
> . . . .
>
> The corporation is an institution and its reality lies not in legalistic definitions but in the part the corporation plays in the complex balance of forces that constitutes the economic world of the present time.[17]

Obviously it is difficult to achieve scholarly agreement on the conception of a corporation. Likewise, it is historically obscure how the concept of limited liability became handmaiden of the separate entity theory. Dewing's explanation is quite simply: "The legal attributes of the corporation are mere accidents of historical development. . . ."[18] He believes limited liability became a *sine qua non* of corporateness because it was, and is, a basic assumption of businessmen. Such immunity is in fact not an "essential characteristic" of corporateness, but an attribute "which, for reasons of social expediency, it seems desirable to attach to the modern corporation."[19] According to Dewing the attributes of corporateness are determined by the economic and social environment of the time and what "[man's] laws propose; the underlying forces of economics dispose."[20] Deiser, seemingly in accord, regards the immunity of

15. *Id.* at 18 n.t.
16. 1 G. HORNSTEIN, *supra* note 6 § 22: "The Courts do not attempt to fit every corporation into a single Procrusteanbed." *See also* R. STEVENS and H. HENN, *supra* note 8 at 37-46 for one of the more complete casebook discussions of theories of corporateness.
17. 1 A. DEWING, FINANCIAL POLICY OF CORPORATIONS 16-17 (5th ed. 1953).
18. *Id.* at 16.
19. *Id.* at 14.
20. *Id.* at 16.

shareholders from business debts as merely an incident of the corporation's holding of property, but not a "necessary incident."[21] Both suggest the two concepts are by no means historically, legally, or logically coextensive.

This latter point has been discussed by Professor Kessler who has asked whether "limited liability" is a "natural right" of the corporation and of no other business form."[22] His succinct review of the historical evolution of the concept leads to the finding that "the corporation . . . does not have a monopoly on the valuable business privilege of limited liability."[23] Examination of such authorities as Holdsworth, Dodd, Williston, and Stevens produce inconclusive evidence on the question of whether limited liability is a "natural right" which necessarily inheres in corporateness.[24] Kessler is properly guarded in using the term "natural right" in light of the admonishment:

> There is nothing absurd in the statement that there are no such things as the natural rights of corporations. Certain of them are in their nature impossible. . . . There is no need to visualize further the juristic person. . . . The fact exists that the moment a powerful group begins to act toward a common end it produces a capacity for aggression that individuals can only in the rarest cases combat. It presents the old problem of genus against species and the genus must . . . prevail.[25]

The problem of determining the relation of limited liability to corporateness is further complicated by the fact that pinpointing the origins of the modern corporation is frustrating and unrevealing. Kessler, for example, mentions the Romans, Greeks, Hammurabi and further back, but then notes our fount of law, England, adopted limited liability on a general basis only in 1855.[26] There are also of course historical analogues of the modern corporation,[27] but their development does not elucidate the connection between corporateness and limited liability. As Dewing states:

> The difficulty in all this research is to define, with any degree of precision, the exact point in the evolution of business or other associations when some inarticulate but

21. Deiser, *supra* note 1, at 235.

22. Kessler, *supra* note 1, at 237-38. *See also* Machen, *supra* note 11, at 350.

23. Kessler, *supra* note 1, at 242.

24. *Id.* at 234-46. *See also* BERLE, *supra* note 9 at 1-25; 1 DEWING, *supra* note 14, at 19-21.

25. Deiser, *supra* note 1, at 302.

26. Kessler, *supra* note 1, at 240-41. *See also* Gower, *Some Contrasts Between British and American Corporation Law* 69 HARV. L. REV. 1369, 1370-71 (1956).

27. A. DEWING, *supra* note 14, at 22-27. *See also* A. BERLE, *supra* note 9, at 6-11.

> nevertheless realistic form of organization became a business corporation in our sense of the term.[28]

Historical evidence then leads to the conclusion there is a fortuitous but not a determinate interrelation between the concepts of corporateness and limited liability. Moreover, legal and economic historians cannot demonstrate that limited liability was, and is, associated exclusively with the corporate enterprise. The visible relation between the concepts today is reinforced by the orientation of modern corporation statutes and popular belief, but the fact that modern corporations lack entity attributes for many purposes and that unincorporated associations are granted such status bespeaks the unreality of holding the concepts correlatives. Dewing has stated it most neatly:

> Fundamentally, limited liability rests upon the degree of 'insulation' attributed to a particular corporation. If the insulation were absolute, then limited liability would appear to follow. . . . But the insulation is never absolute. . . . [C]ourts have invariably broken through the formal insulation of the corporation and held the stockholders liable.[29]

Consequently, counsellor, client, and court must accept an historical verdict which indicates not only that the origins, development, and meaning of the separate entity concept are dubious, but that limited liability is not perforce related to the entity theory.[30] If history offers little comfort the actions of the courts offer even less to the investor-shareholder seeking certainty in his immunity. For years the courts have denied the limited liability for the purposes of convenience, achieving justice, and avoiding the rewarding of wrongdoers. Essentially a court's response to pleas to "shuck" limited liability has been governed by the equities of the particular case. Thus any generalizations about rigid or liberal judicial tendencies in this area are apt to be misleading.

II. A CURRENT OVERVIEW OF LIMITED LIABILITY AND DISREGARDING CORPORATENESS

Doubtless the most widely used form of business association and that which represents the greatest concentrated economic wealth in the nation is the corporate enterprise.[31] Public policy generally

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28. 1 A. DEWING, *supra* note 14, at 21.
29. *Id.* at 14.
30. Using these two concepts as an exclusive basis for corporate rule-making is surely beset with pitfalls. Assuming them to be the touchstones of corporate problem solving may cause "infinite harm." Machen, *supra* note 11, at 357. *See also* Comment, *"Corporate Entity"—Its Limitations as A Useful Legal Conception*, 36 YALE L. J. 254 (1926).
31. J. GALBRAITH, THE NEW INDUSTRIAL STATE (1967) reflects this fact regarding America's two hundred largest companies. *See also* R. STEVENS and H. HENN, *supra* note 8, at 31-34.

favors creating and maintaining a social and economic milieu attractive to business companies. Limited shareholder liability is consistent with this policy and contrary judicial inclinations are unlikely to be well received. This policy modernly applies irrespective of the type of corporation involved. One valid distinction to draw among different kinds of American business corporations is in terms of the economic function each serves. The publicly-held corporation is primarily designed to serve from incorporation the function of accumulating capital while incorporation of the typical close corporation is intended to emphasize the existence of a legal entity distinct from its participants.[32]

In the United Kingdom, where the public-private company dichotomy exists, it has been stated:

> The company . . . formed may be either (1) a company having the liability of its members limited by the memorandum [of association] to the amount, if any, unpaid on the shares respectively held . . . (termed a company limited by shares . . .); or (2) a company having the liability of its members limited by the memorandum to such amount as the members may . . . undertake to contribute to the assets of the company in the event of its being wound up (termed a company limited by guarantee . . .); or (3) a company not having any limit on the liability of its members (termed . . . an unlimited company . . .).[33]

In the United States this legal diversity respecting shareholder liability does not exist, although there is no apparent reason to prevent shareholders by contract or by appropriate provision in the articles of incorporation from enlarging their personal liability.[34] Several state constitutions and most states in their business corporation enabling laws expressly limit the liability of a shareholder or subscriber to pay only the full consideration for which such shares were issued or to be issued.[35] At least twenty-one states closely follow section 23 of the Model Business Corporation Act which preserves limited liability, and other states, in varying degrees, ad-

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32. A. BERLE, THE 20TH CENTURY CAPITALIST REVOLUTION (1954).

33. 6 HALSBURY'S LAWS OF ENGLAND § 226 (3rd ed. 1955) (citations omitted). *See* L. GOWER, THE PRINCIPLES OF MODERN COMPANY LAW (1954).

34. No cases have been found raising this exact point, but arguably a private contract or a clause in the articles or by-laws enlarging the personal liability of shareholders for business debts could be held to contravene express public policy limiting such liability. *See* Sensabaugh v. Polson Plywood Co., 135 Mont. 562, 342 P.2d 1064 (1959) (invalidating an attempt to use corporate machinery to nullify the mandatory cumulative voting provision in the state's constitution). Since the privilege of limited liability is designed to protect shareholders, they presumably may knowingly consent to waive it. Further, barring such arrangements might interfere with the common practice of investors in close corporations using personal credit to borrow funds on behalf of the business. *See also* ABA-ALI MODEL BUS. CORP. ACT § 48(1) (1966).

35. *E.g.*, ALA. CONST. art. 12, § 236; S. C. CONST. art. 9, § 18; W. VA. CONST. art. 11, § 4; IND. STAT. ANN. § 25-205 (h) (Supp. 1968).

here to the substance of section 23.[36] The most recent significant legislation relating to business corporations, the Delaware General Corporation Law, perpetuates this pattern of limited liability protection for shareholders.[37] With a corporate heritage and chiefly statutory backdrop that generally circumscribes the extent of shareholder responsibility for corporate indebtedness it is a difficult task to rationalize the development by the courts of both the "de facto" corporation and "piercing" doctrines. The conflict and incongruity are self-evident. For example, may not the court-derived "piercing" doctrine potentially violate the separation of powers limitation, or worse, in the light of legislative and, especially, constitutional approbation of limited liability, a state public policy? This possibility appears to have been little litigated and probably will be ignored. The important point, however, is that legislative dominance of corporation structure and governance should make courts somewhat cautious in extending a doctrine opposed to a firmly declared public policy.

However superficially contradictory to the legal privilege of limited liability the "piercing" doctrine may seem, it is widely available in a variety of situations to impose liability on shareholders beyond their immediate or prospective obligation to pay the corporation for shares subscribed for or purchased.[38] Perhaps in no

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36. ABA-ALI. MODEL BUS. CORP. ACT ANN. § 23, par. 2.01, 2.02 (Supp. 1966). Such protection may also extend to shareholders of businesses exempted from the state's general corporation act. *E.g.*, IND. STAT. ANN. § 39-3704 (c) (1965) (insurance companies). There are, however, exceptions which extend the liability of shareholders for business debts. For example, until 1963 the Michigan Constitution provided: "The stockholders of every corporation and joint stock association shall be individually liable for all labor performed for such corporation or association." MICH. CONST. art. XII, § 4 (1908). The West Virginia Constitution excepts "banking institutions" from its limited liability provision. W. VA. CONST. art. 11, § 4. Individual shareholders of a national banking association formerly were held "individually responsible, equally and ratably" for its debts to the extent of their stock investment. 12 U.S.C. § 63, this section was repealed by Act of Sept. 8, 1959, Pub. L. No. 86-230, § 7, 73 Stat. 457. *See* 12 U.S.C. 56 (1964). Corporation statutes also deviate from the privilege of limited liability in certain cases. Shareholders of specified institutions such as banks and trust companies are affected. *E.g.*, IND. STAT. ANN. § 18-1902 (1964). New York imposes liability for unpaid employees' wages on the ten largest shareholders of corporations whose shares are not listed on national securities exchanges or regularly quoted in the over-the-counter market by members of a national or affiliated securities association. The employee is required to furnish notice of his claim against the shareholders within a specified time after terminating his employment. This provision obviously encompasses close corporations. N.Y. BUS. CORP. LAW § 630 (McKinney Supp. 1968). A shareholder who "knowingly" receives a dividend or distribution made in violation of a corporation statute may have to contribute to a director against whom a claim is asserted for approving such action. *E.g.*, 12 U.S.C. § 56 (1964); IND. STAT. ANN. § 25-251 (e) (Supp. 1968). This liability may indirectly accrue to the benefit of creditors. *See* ABA-ALI MODEL BUS. CORP. ACT § 43 (1960), after which the Indiana provision is patterned, providing for the personal liability of directors and officers on the basis of engaging in a variety of impermissible actions. In close corporations shareholder-managers could easily incur liability under this section.

37. DEL. CODE ANN. tit. 8 §§ 162 (a), 325 (1967) *but see id.* § 102 (b)(6) which provides that the certificate of incorporation may include a provision imposing personal liability for corporate debts on its stockholders to a "specified extent and upon specified conditions." A generous six year statute of limitations period is provided for bringing the action to recover the amount of the unpaid balance of the consideration owed by the subscriber or holder. *Id.* § 161(d). Shorter limitation periods exist in many states. *E.g.*, IND. STAT. ANN. § 25-205(h) (Supp. 1968) (three years).

38. Apparently the "piercing" doctrine is usually invoked only against the shareholders of business corporations. Few cases applying the doctrine to members of a nonprofit cor-

other area of corporate law has such a rich argot of judicial labels of formulations grown up as in cases involving the question of disregarding corporateness.[39] The handicap of the labels is of course their inutility as analytic tools in ascertaining when the doctrine should apply to shred corporateness. Delineation of a specific standard encompassing all corporations is as unworkable as is a statement of all the significant elements which should be applied to different types of corporations in different contexts for determining the applicability of the "piercing" doctrine. However, the legislative and judicial trend in this country is to distinguish between different types of corporations by accommodating special needs of the close corporation (which term includes one man, family and other limited member corporations).[40] This tendency is paralleled by an effort to make a distinction in stating the standards for applying the "piercing" doctrine to close corporations and to subsidiary and other affiliate corporations when imposing liability on a parent company.[41]

Corporate writers and commentators, for example, distinguish between closely-held corporations and parent-subsidiary relationships in enunciating the substantive standards or elements which comprise the "piercing" doctrine.[42] Henn seems to insist three tests must be met for the close corporation to retain the limited liability advantage: formation for a legitimate purpose; conducting business in a corporate as opposed to a personal manner; and, beginning with an adequate capital structure.[43] With respect to parent-subsidiary and/or affiliate relationships he suggests five standards to prevent the business units from being treated as assimilated, namely: formation for a legitimate purpose; maintenance

poration have been found. *See* Garden City Co. v. Burden, 186 F.2d 651 (10th Cir. 1951). Members of a nonprofit corporation are generally responsible only for such dues or assessments as are levied under the authority of the articles or by-laws. R. BOYER, NON-PROFIT CORPORATION STATUTES: A CRITIQUE AND PROPOSAL 159 (1957). There would seem to be no objection to applying the doctrine to nonprofit corporations as well as to organizations formed under the new medical, dental and professional incorporation statutes. *See* H. OLECK, NON-PROFIT CORPORATIONS AND ASSOCIATIONS (1956). R. STEVENS AND H. HENN, *supra* note 8, at 176-86 list by state and discuss the "professional" corporation statutes.

39. H. HENN, *supra* note 6, at 203 n.2.

40. *E.g.*, DEL. CODE ANN. tit. 8, §§ 341-356 (1967); Galler v. Galler, 32 Ill.2d 16, 203 N.E.2d 577 (1964).

41. *See* text *infra*.

42. *See* the hornbook authorities cited in note 6, *supra*. In addition to close corporations and public issue companies it may become necessary to consider the plight of so-called "middle" corporations. *See Folk, Roundtable on Business Associations*, 20 J. LEGAL ED. 511, 519-21 (1968).

43. H. HENN, *supra* note 6, at 205-06. Henn was selected chiefly because his is one of the recent corporate law hornbooks and his views are incorporated in the casebook he co-authored. Henn's preliminary analysis confirms the unavoidable vagueness of the "piercing" doctrine:

> The general rule . . . is that corporateness—with attendant corporate attributes will be recognized and will not be disregarded. . . . The test is simply whether or not recognition of corporateness would produce unjust or undesirable consequences inconsistent with the purpose of the concept. The concept will be sustained [only] . . . for legitimate purposes. *Id.* at 204-05.

of separate transactions, accounts, and records; observing corporate operating procedural norms (meetings, minutes, voting, etc.); adequately capitalized subordinate units; and distinct public business images.[44] Resort to such categorical tests in the application of a highly elastic doctrine is not wholly satisfactory.[45] A rigid enumeration of the elements to be used for different kinds of corporations or a mechanistic mode of analysis implies an immutability which is simply incongruent with an equitable doctrine as flexible as that of disregarding corporateness. As will be seen, courts facing the doctrine ought to be preoccupied with the fundamental equities of the particular case and need not concern themselves principally with the respect shown all the statutory and corporate usages of internal operation and the manner of doing business. They also should employ the doctrine, which will be treated in detail later, in a manner which discriminates between corporations and develop different criteria for its application to disparate enterprises and relationships.

III. DISREGARDING THE FICTION: CONTEMPORARY PERSPECTIVE

A. The Nature of the Corporation

Close Corporations

As Dean O'Neal has observed, legislatures and courts have increasingly recognized that the special needs of close corporations require legal privileges generally unavailable to public corporations.[46] The movement began in 1948 in New York,[47] expanded with the 1955 North Carolina statute,[48] and peaked in 1967 with the new Delaware General Corporation Act.[49] The state enactments generally simplify or eliminate formalities, approve internal control methods similar to partnership arrangements and minimize the drastic consequences of deadlock.[50] These statutory innovations

44. *Id.* at 206-07.
45. *E.g.*, Comment, *supra* note 6.
46. O'Neal, *Developments in the Regulation of the Close Corporation*, 50 CORNELL L.Q. 641 (1965). Dean O'Neal believes the limited liability and separate entity concepts should apply to the close corporation. F. O'NEAL, *supra* note 6, at § 1.10. *See also* Folk, *Roundtable on Business Associations*, *supra* note 42 at 514-15. The rapid pace of legal developments involving close corporations is reflected in law school curriculum changes. Hornstein, *The Close Corporation*, 21 J. LEGAL ED. 93 (1968). The close corporation is not uniquely American. It exists, for example, in Britain [McFadyeon, *The American Close Corporation and Its British Equivalent*, 14 BUS. LAW 215 (1958)], France [Treillard, *The Close Corporation in French and Continental Law*, 18 LAW & CONTEMP. PROB. 546 (1953)], and Germany [Schneider, *The American Close Corporation and its German Equivalent*, 14 BUS. LAW 228 (1958)].
47. *See* de Capriles and Reichardt, 1947-1948 *Survey of New York Law—Corporations*, 23 N.Y.U. L. Rev. 747 (1948).
48. *See Latty, The Close Corporation and the New North Carolina Business Corporation Act*, 34 N.C.L. REV. 432 (1956).
49. *See* Comment, *Delaware's Close-Corporation Statute*, 63 NW. U.L. REV. 230 (1968). *See also* Bradley, *A Comparative Evaluation of the Delaware and Maryland Close Corporation Statutes*, 1968 DUKE L.J. 525.
50. Bradley, *supra* note 49, at 525-26 asserts:

> It will be the author's thesis that close corporation legislation should be animated by two fundamental principles. First, a very far reaching contractual

are complemented by several one or two man directorship statutes.[51] If the underlying purpose of such statutes is realization of the need of the participants of the close corporation to operate like partners, the criteria now used to determine whether or not to deny the protection of limited liability will clearly have to undergo some refinement and alteration.[52] Particularly, reliance on the members complying with the statutory formalities or the fact an individual owns all the shares or dominates the concern may have to be discarded or modified as viable criterion.[53] Probably the emphasis of the doctrine should shift to a requirement that, within the limits of the statute, the partnership operate in a businesslike manner, not as an unfettered, personal fiefdom or proprietorship, that the separate identity of corporate assets and individual property be scrupulously preserved, and, more importantly, that there be adequate capital to ensure against insolvency and reasonably anticipated risks.

There are good social and economic reasons for permitting the close corporation, whether an incorporated proprietorship, partnership, or family business, to possess and enjoy the same benefits of incorporation extended to the public issue corporation.[54] Numerically this class of corporation is our most important for it has been estimated that it is being organized in this country at a twenty-to-

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> freedom should be extended to business associates to structure the ultimate and day-to-day control of the business, to make arrangements for allocation of the earnings and for asset distribution, and to establish ground rules for the transfer of ownership interests and the dissolution of the corporation.... Close corporation statutes should be completely permissive with respect to how the business is to be run.

See O'Neal, *supra* note 46 to the same effect. Naturally advocacy of contractual freedom for close corporation investors coextensive with that enjoyed by partners is the root cause of charges that the public interest is endangered. This could lead one to view the "piercing" question in part as a struggle over the extent freedom of contract will be inhibited by the courts.

51. *See* Rudolph, *Further Thoughts on the One and Two Director Statutes,* 20 BUS. LAW 781 (1965); ABA-ALI MODEL BUS. CORP. ACT ANN. 634, para. 202 (2) (Supp. 1966).

52. The literature on close corporations indicates that the recent special legislation leaves many questions unresolved. For instance: what is the best test for differentiating the close corporation from the non-close corporation; how severe may stock transfer restrictions be; or what remedies are to be permitted in the event of an impasse or threat of dissolution? *See* articles cited *supra* note 49. But for the purposes of the effect on the "piercing" doctrine another possible aspect of the close corporation statutes becomes important. Professor Folk feels that there is a risk such difficulties with the statutes may cause states to adopt acts which are too "vague and lenient." Folk, *Roundtable Discussion on Business Associations, supra* note 42 at 515. A possible result could be greater judicial willingness to apply the doctrine to counter the absence of statutory regulation.

53. 1 F. O'NEAL, *supra* note 6, at § 1.10 indicates observance of statutory norms is one of several major tests in applying the "piercing" doctrine to close corporations. The other class of cases involve inadequate financial resources. A third O'Neal theory is discussed in note 78, *infra.* But both the new close corporations acts and recent judicial decisions indicate that such norms were designed mainly to protect investors in public companies and may be dispensed with in regard to such corporations. *See* Galler v. Galler, 32 Ill.2d 16, 203 N.E.2d 577 (1964); Arsht and Stapleton, *Delaware's New General Corporation Law,* 23 BUS. LAW 75, 90-93 (1967).

54. Even critics who view the latitude given close corporation managers (if not all management) as a perilous development seem to grudgingly acknowledge the existence of some benefits. Tennery, *The Potential of the Close Corporation*: A QUESTION OF ECONOMIC VALIDITY, 14 HOW. L.J. 241 (1968). On the other hand, proponents of close corporation legislation may not give enough thought to the potential harm to the public interest resulting from the widest possible contractual freedom. COMPARE Folk, *Roundtable Discussion on Business Associations, supra* note 42 *with* Bradley, *supra* note 49.

one ratio compared to publicly-held companies.[55] It is obviously the intention of legislatures and some courts to facilitate and encourage the formation and development of close corporations:

> [T]he close corporation has become the 'ideal' arrangement for the small business. It has the best of two worlds; it can operate in the informal manner characteristic of the partnership, but with corporate protection, and without necessarily suffering a tax disadvantage.[56]

It is reasonable to assume that the principal motivation for organizing most close corporations is to secure the immunity that accompanies incorporation. This fact combined with the new and accelerating statutory and judicial permission to depart from well-defined norms of behavior and regular procedures raises important questions concerning the extent to which the legitimate interests of creditors and the general public may require further protection.

For example, Dean Tennery questions the potential danger to such noncorporate parties arising from the informal and free wheeling manner in which the close corporation may now function:

> It is also an ability that should provoke greater criticism, since the ability to organize and to manage according to the desires of the parties, rather than following the dictates of some standard, can lead to excessive maneuverability that may adversely effect the rights of innocent parties. An *ex post facto* judicial finding of improper conduct is small comfort for the unpaid creditor.[57]

Other sources of concern include the absence of personal accountability for the participant's actions (as in partnerships) which may breed greater imprudence in risk taking and the lack of a disinterested individual or group (like outside shareholders or directors in the public corporation) who will criticize or act as a counterforce if a dubious course of action is adopted. Tennery strongly argues:

> Should the participants decide on a course of action of extreme financial risk, this can be done and the potential assumption of the risk can, to some extent, be placed on other than the members of the corporation. . . . [T]he close corporation is a device of great potential abuse because of its inherent nature and the attitudes of those normally

55. *See* Tennery, *supra* note 54, at 253. Hornstein notes that since there are about 100,000 elections annually under Subchapter S for federal income tax purposes the number of operating close corporations must be many times greater. Hornstein, *supra* note 46, at 95. *See also* R. STEVENS and H. HENN, *supra* note 8, at 30.

56. Tennery, *The Potential of the Close Corporations: A Question of Economic Validity*, 14 HOW. L.J. 241, 255 (1968).

57. *Id.* at 253.

> expected to supervise . . . corporation conduct. . . . [T]he close corporation may begin business with little or no risk capital by the members, or their investments may be hedged by acquiring a secured position . . . or equity capital . . . may be quickly returned to the contributing shareholders and thereby leaving the risk of financial failure to creditors and general public.[58]

Undeniably this lugubrious assessment of the risks that could be thrust on creditors and the public by unprincipled or careless close corporation managers is more than a speculative possibility.

On the other hand, there would seem to be at least three countervailing factors. First, it is extremely difficult to substantiate such charges of excessive close corporation misuse, actual or potential. The period of experience under the new close corporation statutory provisions has been too short and the reported cases do not seem to indicate the privilege of limited liability is producing extensive abuse. Nor does it seem naive to assume that most small corporations are, and will be, organized to carry on ordinary business in an acceptable way. Second, the benefit of achieving partnership flexibility under the new statutes is generally purchased only at a price. Where a shareholder's management agreement replaces the board of directors the effect is to impose on the participating shareholders ordinary management liability more or less coterminous with the control provisions of the contract.[59] Third, if relaxation of close corporation regulation does increase outsider's risk-taking in transactions the doctrine of disregarding corporateness will continue to offer a reasonable measure of protection.[60] The prevailing legal analysis used in applying the doctrine will be discussed elsewhere. It bears underlining that the close corporation is highly amenable to the doctrine because it is the type of corporation

58. *Id.* at 256. Tennery sees corporation law proceeding to develop in two unrelated directions: the control of "insider" activity in publicly-held corporations and liberating close corporations from the "norm" structure. *Id.* at 245. *See also* Cohen, *Federal Corporation Law*, 20 J. LEGAL ED. 529 (1968); Folk, *Corporations Statutes*: 1959-1966, 9 CORP. PRAC. COMM. 111, 231 (1967).

59. *E.g.*, DEL. STAT. ANN. tit. 8, § 350 (1967) provides:

> A written agreement among the stockholders of a close corporation holding a majority of the outstanding stock entitled to vote, whether solely among themselves or with a party not a stockholder, is not invalid, as between the parties to the agreement, on the ground that it so relates to the conduct of the business and affairs of the corporation as to restrict or interfere with the discretion or powers of the board of directors. The effect of any such agreement shall be to relieve the directors and impose upon the stockholders who are parties to the agreement the liability for managerial acts or omissions which is imposed on directors to the extent and so long as the discretion or powers of the board in its management of corporate affairs is controlled by such agreement. *See also* FLA. STAT. ANN. § 608.0105 (3) (Supp. 1964); N.Y. BUS. CORP. LAW § 620 (f) (McKinney 1963).

60. *Contra*, Note, *Should Stockholders be Personally Liable for the Torts of Their Corporations?*, 76 YALE L.J. 1190, 1192-96 (1967). Tennery, *supra* note 54 does not address himself to this point but probably would conclude that the "piercing" doctrine offers inadequate protection.

most frequently formed, it is the least likely to be well managed or have sufficient resources, and it creates less theoretical and practical difficulty with the entity and limited liability concepts because of its similarity to the partnership.[61]

The Publicly Held Corporation

The public corporation, or for that matter the large close corporation, should present little opportunity to apply the doctrine.[62] It is reasonable to expect that such business units will be competently managed and suitably financed and equipped to absorb risk-losses which might otherwise require recourse to the doctrine. However, for years public corporations have demonstrated a remarkable propensity to form independently incorporated subordinate units—subsidiaries or affiliates[63]—thereby establishing a relationship commonly characterized by two factors, the parent corporation's dominance, control or ability to manipulate the subsidiary through ownership of all, or a majority of, the sub-unit's voting stock and a substantial management identity. There appears to be an upsurge, rather than an abatement, of this process in the recent wave of mergers and acquisitions.[64] The multifarious purposes underlying the setting up of such a relation include further insulation of the parent corporation.[65] It should be noted such a relationship is not necessarily confined to large publicly held corporations for it is quite feasible to create the same structure with close corporations, or, for that matter, form multiple close cor-

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61. Definitional problems aside, it is perhaps most accurate to describe the close corporation as "incorporated partnership" for "it has the intimacy and association of the partnership with the vital trappings of the corporation, such as limited liability, separate entity and permanent capital structure." Tennery, *supra* note 54, at 250. Kessler, *supra* note 1 argues that small businessmen need operational flexibility and limited liability protection and should not be denied these advantages. But he also recognizes that protection of the public interest and creditors is essential. The major drawback is that too few states endeavor to accommodate the small businessman and those with close corporation statutes tend to complicate matters. *Id.* at 252-58. He therefore proposes a "Partnership Corporation" statute with suitable provisions, such as notice of the form of the business and requirements for maintaining adequate and separate funds and records to protect the public. Also, the "Partnership Corporation" would be available only to enterprises of limited size. *See id.* at 277-306 for the provisions of the suggested act. Note especially §§ 1, 2, 14, 16, 17 of Kessler's proposed statute.

62. *Accord,* Note, *supra* note 60, at 1196-98.

63. It might be argued that a different approach is required when dealing with affiliated concerns under the "piercing" doctrine. An affiliate or affiliated company may be a corporation that controls or is controlled by another concern, directly or indirectly, through one or more intermediary companies. Apparently many of the same fators are used in "piercing" cases whether the affiliates are parent-subsidiary or brother-sister concerns. R. STEVENS and H. HENN, *supra* note 8, at 375-76. *See also* N. LATTIN, R. JENNINGS, and R. BUXBAUM, *supra* note 8, at 155-56; Comment, *supra* note 6.

64. N.Y. Times, Nov. 17, 1968 § 3, at 1f, col. 3, and 14f, col. 5 (The number of mergers rose 25 per cent in 1967 (2,975) and is projected to increase 41 per cent in 1968 (4,200). *See also* N.Y. Times, Dec. 8, 1968 § 3, at 1f, col. 1, and 10f, col. 3 discussing "mini"—conglomerates.

65. *See* H. OLECK, MODERN CORPORATION LAW § 1802 (student ed. 1960) for a straightforward enumeration of the major purposes for forming subsidiaries. *See also* BERLE, *supra* note 9, at 153; LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS (1936); Cataldo, *Limited Liability With One-Man Companies and Subsidiary Corporations*, 18 LAW & CONTEMP. PROB. 473, 487-88 (1953).

porations all of which concentrate on the same line of business.[66]

Generally the parent-subsidiary relationship is distinguishable from the close corporation structure in several respects and therefore necessitates a somewhat different approach when employing the "piercing" doctrine.[67] The most obvious distinction is the potential dual liability, that is, the parent being responsible for the subsidiary's contracts and torts and the subsidiary being charged with the wrongdoing of the parent. Second, the vast majority of subsidiaries are attached to large parent companies having abundant executive talent and financial resources which filter down to the sub-unit. Consequently, the likelihood of the subsidiary having lackadaisical management and inadequate capital is reduced. Third, with notable exceptions, modern corporation enabling statutes have been designed to serve the needs of large public corporations. The statutory prescription of procedures and formalities to be followed generally precludes management of such concerns operating as partnerships and thereby attempts to protect both shareholders of the corporation and its creditors. The potential manipulative practices Dean Tennery envisions in the "unregulated" close corporation environment should not exist to the same degree in the parent-subsidiary relationship even though it is apparent modern corporation statutes attempt to maximize the freedom of management decision making and the public shareholder exerts minimal restraint on management actions.[68] Fourth, the regulatory impact and consequences of state and federal business laws and the development of a code of corporate ethics by the federal courts and the Securities and Exchange Commission tend to mitigate the ability of larger business units and their subsidiaries to undertake activities likely to result in public harm.[69] Nonetheless the modicum of cases applying the doctrine in the parent-subsidiary context affirms that it remains a continuing problem.[70]

66. *See e.g.*, Walkovsky v. Carlton, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966).

67. N. LATTIN, R. JENNINGS, and R. BUXBAUM, *supra* note 8, at 155 state: "It does not seem that intercorporate relationships should be subject to different tests of ["piercing"], despite occasianal suggestions to this end." *See* discussion in text *infra*.

68. The separation of control from ownership is commonplace and has caused considerable agitation about the modern shareholder's powerlessness. F. EMERSON and F. LATCHAM, SHAREHOLDER DEMOCRACY: A BROADER OUTLOOK FOR CORPORATIONS (1954).

69. Principally these developments have occurred under the federal securities acts; especially, section 10(b) of the SECURITIES EXCHANGE ACT of 1934 and Rule 10b-5. Aggressive Securities and Exchange Commission action against the Texas Gulf Sulpher Company and the brokerage firm of Merrill Lynch, Fenner, Pierce and Smith exemplify this trend. A higher fiduciary code of conduct is evolving for the business and financial community. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968); Escott v. BarChris Corp., CCH FED. SEC. L. REP. para. 92, 179 (S.D.N.Y. March 29, 1968); Gary, *Corporate Standards and Legal Rules*, 50 CALIF. L. REV. 408 (1962).

70. *E.g.*, Weyerhaeuser Co. v. United States, 395 F.2d 1005 (Ct. Cl. 1968). *See* 1 W. FLETCHER, *supra* note 6, § 43 and collected cases.

Current Standards

In formulating standards for disregarding corporateness, either of a close corporation or in the parent-subsidiary affinity, considerable similarity exists among the various tests applied to each situation. In addition, in both situations the courts have fallen victim to the "mists of metaphor" in explaining the imposition of personal liability on shareholders for corporate debts.[71] Also the courts seem to concur that it is beyond cavil to assert that evidence showing that incorporation was solely to achieve limited liability is sufficient to justify puncturing the immunity or even a material factor in applying the doctrine.[72] This position is both defensible and logical and the doctrine itself is not usually advanced by a consideration of this point. The legal and business community have too long accepted limited liability as a corallary to corporateness, and state statutes and some constitutions expressly grant this benefit. Thus discussion of this purpose may sometimes be irrelevant to the justice of the outcome in a particular case.

Rarely is the formulation of criteria for disregarding corporateness sufficiently complete, accurate, or comprehensible. It is the contention of this article that the doctrine of disregarding corporateness embraces several legal approaches which are always multifactor and that the doctrine's continued vitality depends on the very imprecision which might cause some legal critics to denounce it.[73]

Legislative and judicial authorization for close corporations to depart from long standing norms of corporate behavior certainly presage the need for a new, disencumbered approach. The recent case of *Zubik v. Zubik & Sons, Inc.*, involving the issue of the imposition of personal liability on a close corporation's major shareholder in an admiralty action seems to represent the most common yet realistic approach.[74] The court found it permissible

71. The "mist of metaphor" phrase is that of Judge Cardozo in the well known case of Brekey v. Third Ave. Ry. Co., 244 N.Y. 84, 94, 155 N.E. 58, 61 (1926).

72. *E.g.*, Walkovszky v. Carlton, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966). This case is apparently being relitigated on an amended complaint 287 N.Y.S.2d 546 (App. Div. 1968).

73. Courts agree by regarding each "piercing" case as distinctive. *E.g.*, Pagel, Horton & Co. v. Harmon Paper Co., 236 App. Div. 47, 49, 258 N.Y.S. 168, 171 (1932).

74. 384 F.2d 267 (3d Cir. 1967), *cert. denied*, 390 U.S. 988 (1968). In that case, the defendant, for reasons of poor health, formed a corporation in which his two children were the other shareholders and principal managers and orally leased his fleet of barges to the corporation. The evidence in the case presented difficulty in determining whether to apply the "piercing" doctrine. In favor of the doctrine's application was evidence that the corporation paid defendant's salary and rent to a corporate account and also paid his per sonal expenses, corporate meetings were not held for several years, only defendant was empowered to sign corporate checks, defendant loaned money to the corporation, the corporation retained some of his personal papers and defendant enjoyed a veto power over corporate decisions. Proof precluding application of the doctrine included the fact that defendant's daughter had a power of attorney to sign corporate checks, the corporation borrowed funds from other sources and had its own assets, and defendant was not active in supervising its daily operations. The action arose when some of the corporation's barges broke their moorings and drifted into other vessels thereby damaging them.

and understandable for an ill man engaged in a business subject to the risk of constant litigation to obtain the security of limited liability when he no longer could actively manage his business. The test stated is clearly equitable:

> [T]he appropriate occasion for disregarding the corporate existence occurs when the court must prevent fraud, illegality, or injustice, or when recognition of the . . . entity would defeat public policy or shield someone from liability for a crime.[75]

Unfortunately, the Court seemed hidebound to the utility of the separate entity theory but its view that limited liability should not be lost "unless specific, unusual circumstances call for an exception" is sound. More significantly the court stated:

> Limiting one's personal liability is a traditional reason for a corporation. Unless done deliberately, with specific intent to escape liability for a specific tort or class of torts, the cause of justice does not require disregarding the corporate entity. The corporate form itself works no fraud on a person harmed in an accident who has never elected to deal with the corporation.
>
> Once fraud or injustice demand piercing the corporate veil, then the intertwining of personal affairs with a family corporation . . . provide additional grounds. . . . [T]he failure of various corporate formalities either contributes to the fraud involved or strengthens the argument for injustice by holding the individual in effect estopped.[76]

While the significance of the nature of the claim will be dealt with subsequently, the broad dimensions given the "piercing" doctrine in the *Zubik* case should apply whether or not the claimant's action is based on a tort or contract. *Zubik* clearly views the doctrine as outcome oriented by virtue of its emphasis on balancing the equities and a multiplex analysis. It recognizes that mixed motivations are involved in incorporating but creates difficult evidentiary problems by referring to "specific intent."[77]

Zubik's formulation of the doctrine in largely equitable terms as it applies to close corporations (or for that matter a parent-

75. Zubick v. Zubick & Sons, Inc., 384 F.2d 267, 272 (3d Cir. 1967), *cert. denied,* 390 U.S. 988 (1968) (citations omitted).
76. *Id.* at 273-74. This language and the Court's presumption favoring recognition of corporate existence whenever it is challenged create difficulty. *Id.* at 270 n. 2. Plaintiff's burden of rebutting this presumption is made more complex by the reasoning that "piercing" results only on a showing of incorporation with specific intent to avoid specific tort liabilities. To establish such motivation would be virtually impossible and most courts may be reluctant to explore this murky area. Inquiring into the defendant's motivation also seems at odds with the general view that proof of such a primary purpose is not sufficient for "piercing" the veil. *E.g.,* In re Sheridan's Petition, 226 F. Supp. 136 (S.D.N.Y. 1964).
77. *See* the discussion *id.*

subsidiary relation) is probably as precise as is humanly possible. The case does not contribute to understanding the weight accorded inadequate capitalization, but this will be explored later. Nor does it clarify, as it should, the relevance of whether or not corporate formalities are adhered to in light of the modern view that close corporation management may correspond to that of a partnership. In focusing on the mingling of personal affairs with corporate business, however, it delineates another factor in determining whether to "pierce" the close corporation veil. In the close corporation, management and ownership usually coalesce. But this has never been thought to permit the participants to conduct personal activities in the guise of corporate business. When members of the close corporation do carry on private affairs within the ambit of the corporate form, that is, where corporate and personal activities become indistinguishable, a court may impose personal liability on the shareholders.[78] This illustrates the point that, even though it may be permissible to ignore statutory formalities, personal deals must not be executed so as to make them ostensibly close corporation transactions.

In the parent-subsidiary relationship the courts have been freer in using labels to analyze the propriety of applying the "piercing" doctrine.[79] But in this relationship the multi-element analysis seems to predominate. An excellent illustration of his approach is *Palmer v. Stokely* wherein the court, paying homage to the metaphor, deemed the subsidiary "a mere instrumentality" of the parent if:

> (1) the parent owns all the stock; (2) both have common directors and officers; (3) the parent finances the subsidiary; (4) the parent causes the subsidiary's incorporation;

78. *E.g.*, Zaist v. Olson, 227 A.2d 552 (Conn. 1967); African Metals Corp. v. Bullowa, 288 N.Y. 78, 41 N.E.2d 466 (1942); Natelson v. A.B.L. Holding Co., 260 N.Y. 233, 183 N.E. 373 (1932). 1 F. O'NEAL, CLOSE CORPORATIONS § 1.10, 31-32 (Supp. 1968) would subsume this element of the "piercing" doctrine under that category of cases which "focuses on the dominant or sole shareholder's control of the corporation." This category of close corporation "piercing" cases usually involves (1) control of all or most aspects of the business; (2) the use of such control to commit a fraud, violate a law, or perpetrate a dishonest act; and (3) a casual relation between the wrong and control. Whether viewed as a matter of dominance or using the close corporation as camouflage for individual business activities the factor has confused some courts. *E.g.*, Zaist v. Olson, *id.* (applied an "instrumentality" rule to show defendant conducted the business as an individual); Walkovszoky v. Carlton, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966) (referred to the agency concept—which term makes sense only when applied to inter-corporate relations—in finding no evidence defendants were doing business as individuals). Both these cases improperly use labels in emphasizing dominance over corporate affairs to determine whether close corporation participants were actually doing business in their individual capacities. The preeminence of private affairs in the close corporation is more clearly shown by proof of manipulation of funds for the participants' personal convenience. Mull v. Colt Co., 31 F.R.D. 154 (S.D.N.Y. 1962). The lesson is to eschew labels and recognize that while shareholder dominance may be more important to the contract creditor than tort creditor it is generally unrelated to the specific harm. Proof of inadequate corporate funds attributable to poor business planning, deliberately diverting funds, or infusing and withdrawing money for personal advantage is far more important to creditors.

79. Berkey v. Third Ave. Ry. Co., 244 N.Y. 84, 155 N.E. 58 (1926).

> (5) the subsidiary has grossly inadequate capital; (6) the parent pays salaries or expenses of the subsidiary; (7) the subsidiary has no business except with its parent or subsidiary corporation or no assets except those transferred by its parent or subsidiary; (8) directors and officers do not act independently in the interests of the subsidiary; (9) formal legal requirements of the subsidiary such as keeping corporate minutes are not observed; (10) distinctions between the parent and subsidiary and subsidiary and its subsidiary are disregarded or confused; (11) subsidiaries do not have full board of directors.[80]

What the court is actually concerned with is the control or power relation between the corporations which must be so overwhelming and pervasive that one is the "dependent" of the other and therefore liable for the "dependent's" wrongs. Another court, dissecting the parent-subsidiary relationship, held that the factors enumerated in the *Palmer* case determine when the parent possesses the proper degree of control to make the subsidiary an"instrumentality," but required that two other tests be satisfied simultaneously; namely, the parent must perpetrate a misdeed through the sub-unit and the claimant must suffer unfair damage before the imposition of liability on the parent concern.[81]

The control aspect of the parent-subsidiary relation has its counterpart in the close corporation context where the court considers the dominance of certain members over the corporation's affairs in deciding whether to preserve the corporate entity.[82] But otherwise it becomes important primarily in terms of intercorporate dealings and the question of the parent corporation's liability for the subsidiary's actions. It is not disconcerting in the parent-subsidiary relation to find the court stressing control in examining the corporate interconnection and holding the subsidiary a "mere department, agent or instrumentality." However, it does not seem particularly constructive for a court to search for the existence of an agency or other labelled relation, although the court may find such a characterization helpful because of its familiarity. Instead, most courts properly focus initially on the extent to which the parent in reality dominates or controls the subsidiary thereby allowing it to achieve advantages unfairly affecting the creditor's

80. 255 F. Supp. 674, 681 (W.D. Okla. 1966). *Accord.* Fish v. East, 114 F.2d 177 (10th Cir. 1940).

81. Stevene v. Roscoe Turner Aeronautical Corp., 324 F.2d 157, 160-61 (7th Cir. 1963). *See also* Lang v. Colonial Pipeline Co., 266 F. Supp. 552, 558 (E.D. Pa. 1967); Zaist v. Olson, 227 A.2d 552, 558 (Conn. 1967). This approach is shared by writers. *E.g.*, H. HENN. *supra* notes 43-45 and accompanying text; H. Douglas and Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 YALE L.J. 193, 196-97 (1929); Cataldo, *supra* note 65, at 488-92; Comment, *Alternative Methods of Piercing the Corporate Veil in Contract and Tort Cases*, 48 B.U.L. REV. 123 (1968).

82. *See* discussion *supra* note 78 involving close corporations.

interests.[83] It is at this point the major substantive legal problem arises in respect of the requisite degree of parental corporate control. The courts can enumerate eleven separate factors for determining the control question, but cannot, and generally do not, resolve whether all the factors or only particular factors need be present. The courts have neither ranked the factors in general or in given fact situations nor indicated whether certain combinations are more significant than other groupings. Plainly each case must turn on its peculiar facts because establishing a hierarchy of factors or preferred combinations for different parent-subsidiary relationships would be futile.[84] It seems reasonable to conclude that courts will not generally require the presence of all the factors in any case and that two of the factors are of great prominence in protecting the parent concern. There should be a showing of a substantial degree of independence of identity, internal management and routine business activities between the parent and subsidiary and the subsidiary must have an adequate financial structure.[85] Also, in contrast to the close corporation, it is evident adhering to corporate norms and formalities will always be a material factor in applying the "piercing" doctrine to the parent-subsidiary relation.

In addition to applying the doctrine on the basis of tests formulated in vague equitable terms, or using metaphoric labels, or statements of manifold criteria, or dominance or control theories, or hackneyed propositions dealing with the separate entity notion and observance of corporate norms, one other proposal, Professor Berle's enterprise entity concept, deserves mention.[86] Professor Berle's theory of defining the enterprise in economic terms is relevant to cases involving multiple close corporations engaged in an identical or similar business under common ownership or control as well as to parent-subsidiary problems. For example in *Mull v. Colt Co., Inc.* in which a tort claimant sued an enterprise consisting of one hundred corporations owning two taxicabs, the Court noted:

> [P]laintiff has joined . . . this complex, seeking to pierce the corporate veil for the purpose of holding the *entire economic entity* liable.
>
> . . . .

83. *See* N. LATTIN, R. JENNINGS, and R. BUXBAUM *supra* note 8, at 154-56 for an interesting discussion of the relevance of dominance. Complete or substantial dominance is not sufficient itself for "piercing" the corporate veil.

84. This seems beyond dispute when one considers that affiliates can be parent-subsidiary or brother-sister corporations and that the possible shades of intertwining are many. *See* Comment, *supra* note 6, at 1131-33.

85. R. STEVENS and H. HENN, *supra* note 8, *at* 375 state that the factors most frequently considered are: degree of financial ownership; domination of the sub-unit's affairs; whether the sub-unit was organized or acquired; its financial condition; and, the "separateness" of the companies. 1 F. O'NEAL, *supra* note 78 § 1.10, 32 (Supp. 1968) suggests similar considerations to protect the close corporation shareholder.

86. Berle, *The Theory of Enterprise Entity,* 47 COLUM. L. REV. 343 (1947).

> If plaintiff can show that there was such a unity of interest and ownership that the independence of the corporations had in effect ceased or had never begun, an adherence to the fiction of separate identity would . . . [permit] . . . the economic entity to escape liability arising out of an operation conducted by one corporation for the benefit of the whole enterprise.[87]

Berle's proposal clearly merits consideration respecting the parent-subsidiary relation as American business companies continually enlarge and decentralize by a process of creating sub-units.

> More often than not, a single large-scale business is conducted, not by a single corporation, but by a constellation of corporations controlled by a central holding company, the various sections being separately incorporated . . .[88]

He suggests such multiple corporations contravene the traditional idea of a corporation and that the "real" enterprise should be defined by the underlying economic facts. This theory is regarded as a means of systematizing the many "rough edges" of corporate law by recognizing the "corporation is emerging as an enterprise bounded by economics, rather than as an artificial mystic personality bounded by forms of words. . . ."[89]

In discussing the doctrine of disregarding corporateness Berle observes:

> The fragile quality of the legal personality created by a corporation is aptly demonstrated. When the corporate fiction is disregarded, an actual underlying enterprise entity may be made to appear. The cases . . . which disregard the corporate fiction . . . seem to stem from the same principle. . . .
>
> . . . .
>
> [I]t is always open to inquiry whether the enterprise-fact corresponds to the corporate-fact. . . .
>
> . . . .
>
> If it be shown that the enterprise is not reflected and com-

87. 31 F.R.D. 154, 157, 163 (S.D.N.Y. 1962) (emphasis added). The Court also mentioned three bases for "piercing" the corporate veil: where fraud or illegality is present; where the corporation is an agent; and, where business is conduced as individuals. *Id.* at 160. Its analysis is not edifying. *See also* Walkovszky v. Carlton, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966), also involving ownership of a taxicab fleet in ten small corporations). The majority opinion noted that there is a difference between contending that the corporation is a "fragment" of a larger enterprise which runs the business and that the corporation is a "dummy" for the shareholders to operate the business "in their personal capacities for purely personal rather than corporate ends." In either instance, according to the majority, the corporation may be an "agent" and the "piercing" doctrine would apply but with different results. In the former situation the entire enterprise would be liable, but in the latter only the shareholders could be reached.

88. Berle, *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 343 (1947).

89. *Id.* at 345.

> prehended by the corporate papers, books and operation, the court may reconstruct the actual enterprise, giving entity to it, based on the economic facts.[90]

Berle's analysis has a logical appeal in certain cases but it does not obviate the need for a multi-factor approach in deciding whether to deny immunity to the shareholders. Moreover, courts generally do not appear to have adopted Berle's theory unless one cares to equate it with the metaphors "agency, adjuncts, instrumentality, or department."[91] The enterprise entity approach also raises difficult questions as to what "economic facts" delimit the enterprise involved.

One of the most compelling factors, applicable to all types of corporations, in judging whether or not to retain limited liability is that of the adequacy of the capitalization of the enterprise.[92] There are no meaningful statutory guidelines in this matter and courts are left to their own ingenuity in developing the content and significance of this element. Questions pertaining to the weight to be given this factor in applying the doctrine, what inadequate capitalization means for different types of corporations and with respect to different claimants, and whether the question of inadequacy is to be ascertained at the time of incorporation or the injury remain largely unanswered. However, some light can be shed.

No court has yet been willing to hold that inadequate capitalization alone is a sufficient ground to disregard corporateness, but it is becoming a material factor in every conceivable case where the defense of limited liability may be challenged.[93] It is doubtful that inadequate capitalization will ever achieve the status of a sufficient, independent legal ground for applying the doctrine but its increasing importance is inexorable.[94] The factor is troublesome to many courts because they have never really considered it or it has been submerged in the multi-factor approach of the doctrine. Courts are also hard pressed to indicate what they actually mean by inadequate capitalization in the absence of predetermined statutory or legal standards and perhaps the paucity of economic evidence

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90. *Id.* at 352, 354.
91. While Berle's "enterprise entity" theory lacks explicit judicial approval it has influenced some decisions. *See, e.g.*, In re Pittsburgh Ry. Co., 155 F.2d 477 (3d Cir. 1946); Hartford Steam Serv. Co., 220 A.2d 772 (Conn. 1966); Hall v. John S. Isaacs & Sons Farms, 146 A.2d 602 (Del. Ch. 1958); Adolph Gottscho, Inc. v. American Marking Corp., 26 N.J. 229, 139 A.2d 281 (1958); and cases cited *supra* note 87.
92. *See, e.g.*, N. LATTIN, R. JENNINGS, *and* R. BUXBAUM, *supra* note 8, at 375. 1 F. O'NEAL, *supra* note 78, at § 1.10, notes the pervasiveness of undercapitalization where liability is imposed under the "piercing" doctrine. The problem of undercapitalization in such cases is not to be confused with "thin" capitalization controversies under the Internal Revenue Code where the issue is whether a security represents debt or equity. *See* Comment, *Thin Incorporation: A Continuing Problem*, 51 MARQ. L. REV. 158 (1968).
93. *See e.g.*, Fisser v. International Bank, 282 F.2d 231 (2d Cir. 1960); Mull v. Colt Co., 31 F.R.D. 154 (S.D.N.Y. 1962).
94. *See e.g.*, Minton v. Cavaney, 56 Cal.2d 576 364 P.2d 473, 15 Cal. Rptr. 641 (1961); Annot. 63 A.L.R.2d 1051 (1958).

and evaluation in the individual cases. Moreover, the factor lends itself to sensible utilization only in the setting of a given case which excludes arbitrary advance formulations or statements concerning it. The significant point is that courts now grasp the conflict and connection between inadequate capitalization and the privilege of limited liability assigned to separate corporate existence:

> Where it is sought . . . to make available to . . . creditors only an illusory amount compared with the size of the business and [its inherent] public responsibility . . . it would be gross inequity to allow such a flimsy organization to provide a shield for personal liability. Courts will not tolerate arrangements which throw all risks on the public and which enable shareholders to reap profits while being insulated against losses.[95]

Courts and writers realize that investors have an obligation to avoid undercapitalization which might cause losses to present or prospective corporate creditors. Capitalization must be commensurate with the nature, extent and conduct of the business which suggests it will not be regarded as a static factor in a situation of expanding or contracting economic conditions. The doctrine of disregarding corporateness should embody the policy that "shareholders should in good faith put at the risk of the business unencumbered capital reasonably adequate for its prospective liabilities."[96] Dewing has noted the divergent usages of the term capital by accountants, businessmen and lawyers, but observes that investors of the profit seeking corporation in order to achieve this end" . . . must first endow [it] with adequate economic resources."[97] To avert the drastic consequences of undercapitalization, organizers, promotors and investors must undertake careful, sophisticated financial planning and forecasting at the time of incorporation and thereafter engage in periodic evaluations of probable financial needs and contingencies. Such planning is habitual for large companies, but the likelihood of this practice may progressively diminish with the size of the business enterprise.[98]

The obligation to provide adequate risk capital begins with incorporation and is a continuing obligation thereafter if the investors are to be permitted to remain free from personal responsi-

95. Mull v. Colt Co., 31 F.R.D. 154, 164-65 (S.D.N.Y. 1962). *See also* Dix, *Adequate Risk Capital: The Consideration for the Benefits of Separate Incorporation*, 53 NW. U.L. REV. 478, 483-84, 492-94 (1958).

96. H. BALLANTINE, *supra* note 6, at 303.

97. 1 A. DEWING, *supra* note 14, at 44.

98. Evidence that financial advice and planning can help to forestall adverse consequences is found in Obre v. Alban Tractor Co., 228 Md. 291, 179 A.2d 861 (1962) (plan for incorporation prepared with assistance of certified public accountants).

bility.[99] Proper capitalization might be envisioned as the principal prerequisite for the insulation of limited liability. Yet this qualified immunity is apparently not enough for some:

> Promoters and dominant, managing and controlling stockholders have not always been satisfied to take even the limited risk. . . . They have sought to make available to general creditors . . . only an amount which is either illusory or trifling compared with the business to be done, while they advance the capital really necessary for the business in the capacity of creditors. In other words, they seek immunity without providing any fund to which creditors may resort. Such a practice will not insulate them from liability for the corporation's debts.[100]

This sort of financial contribution is characterized as "deficiency capital" which precludes the contributor from participating equally in the assets of the company with the public creditors. This raises another difficult question in denying limited liability. What of the ordinary shareholder who merely purchases shares of stock, but is neither a controlling or dominant security holder nor active in management, in the event the court deems the business undercapitalized? If personal liability is to be imposed for corporate debts should it include a shareholder who lacks an effective voice or significant influence in management or who has little or no knowledge of corporate business and actions?[101] It appears that most shareholders who incur personal liability for corporate debts do not fit into this category. The problem is more speculative in the typical close corporation where the members will normally be active participants, but it becomes involuted in more widely held companies where there is a gulf between ownership and management.

Guidelines to ascertain the adequacy of capitalization are necessarily imprecise and complex. What is required is a process of financial and economic analysis in each case. One fact stands out; the juxtaposition of capitalization and limited liability affirms the former's overriding importance.

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99. Dix, *supra* note 95, at 491.

100. Dix, *supra* note 95, at 491-92.

101. Usually this problem is not directly posed where the parent is charged with the subsidiary's acts or a publicly owned company is involved. There is an analogy in cases determining the liability of members of an association in which defective incorporation precludes use of the now largely passe "de facto" corporation doctrine. Partnership liability may not be imposed on passive members. *See* R. BAKER and W. CARY, *supra* note 8, at 60-61, 64-65. In several recent decisions there is some indication that failure to actively participate in the affairs of a close corporation will afford some protection against the "piercing" doctrine. Zubik v. Zubik & Sons, Inc., *supra* note 75; Walkovszky v. Carlton, 18 N.Y.2d 414, 233 N.E.2d 6, 276 N.Y.S.2d 585 (1966) (Keating, J. dissenting); Minton v. Cavaney, 56 Cal.2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961).

> Where risk capital is inadequate, either because initial capitalization was insufficient or because the risk capital subsequently became impaired from any cause, including business adversity, that deficiency must be cured or the business wound up. If the business continues operation with uncured impairment, its obligations will . . . [infect] . . . stockholders personally.[102]

B. The Nature of the Claim

Claims against the corporation assertedly justifying the imposition of personal liability on shareholders will stem from tortious conduct or breach of contract. The different nature of these actions and the varied interests of the claimants demand inquiry whether or not different analysis in disregarding corporateness is required and whether certain interests adversely affected merit more sympathetic consideration in one case than the other. An affirmative response to both questions seems in order. The need for disparate approaches in this area is suggested by language in *Zubik*:

> Cases in bankruptcy or in taxation call for an entirely different evaluation of 'fraud' or 'injustice' than cases of controlled corporate subsidiaries, or as in this instance, a case of corporate tort. The defrauded creditor or 'victim' of a business transaction with an undercapitalized corporation, for instance, often has a strong case for piercing the veil of a 'sham' corporation. The controversy in such cases invariably involves some degree of reliance by the plaintiff, contributing to the fraud, or undue advantage or trick accenting the injustice. But the injured tort claimant stands on a different footing.[103]

It should be reiterated that the problem is most severe with respect to inadequately capitalized close corporations where the amount of the claim exceeds the corporation's assets. Rarely will the tort or contract claimant need to attack the limited liability of shareholders of medium and large corporations enjoying competent management, abundant risk capital and employing other risk absorbing or spreading mechanisms (insurance, special reserves etc.).

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102. Dix, *supra* note 95, at 494.

103. Zubik v. Zubik & Sons, Inc., *supra* note 75, at 273. Writers more often than courts see the need to view contract and tort claims differently under the "piercing" doctrine. *See e.g.*, Cataldo, *supra* note 65, at 475-78; Comment, *supra* note 81, at 134-40; Note, *supra* note 60, at 1192-96. The applicability of the "piercing" doctrine also may be influenced by the type of case presented; such as bankruptcy, taxation, attempt to defeat an express public policy, violation of a penal statute, or the shareholder seeking to disregard the entity for his own benefit. *See* R. STEVENS and H. HENN, *supra* note 8, at 377-400 (breakdown of "piercing" cases by type); 1 W. FLETCHER, *supra* note 6 §§ 34, 37, 39, 44, 45, 45.1, 45.2. The breadth of the doctrine includes international law problems. Note, *Piercing the Corporate Veil Under International Law*, 16 SYRACUSE L. REV. 779 (1965). This article does not try to review the specific types of cases except from the standpoint of the nature of the creditor, but it should be recognized different standards of fraud arise in these cases thereby affecting the determination of whether to "pierce" the corporate veil.

What distinction ought to be made concerning the relationship of the corporation to each type of claim and the claimant's expectations? In the case of contract creditors, analysis centers on the existence of a consensual relation with a business or individual, evidence relating to a particular commercial transaction, and the creditor's reliance on the fact of corporateness and segregated assets or the absence of any appearance or representation of corporateness.

> The obligee of a contractual obligation has an opportunity of knowing and choosing his obligor. He should know with whom he is dealing and should be bound by his choice. If insolvency overtakes the sole shareholder, or the corporation, or both, it is necessary to weigh the respective positions of those who dealt with the business on a corporate basis and those who dealt with the sole shareholder as an individual. The equities of the former are no greater than those of the latter. The former will be limited to the corporate assets; the latter to the individual assets. By this marshalling, the equal equities of both groups are preserved, in the usual and ordinary case.[104]

In outlining standards for disregarding corporateness on behalf of contract claimants the focal point of courts should become criteria which recognize the injured party's reliance on the existence of the corporate form and its presumed assets or the defendant's representations or other evidence of lack of corporateness thereby misleading the complainant.[105] Apart from general equitable considerations underlying the doctrine, several criteria should assume importance. If there is evidence of a corporation then factors such as conforming to corporate norms, not intermingling personal and business transactions and ample capital may be associated with the creditor's reliance. If the defendant in the transaction has excluded any appearance of corporateness or appearances are at best ambiguous it is entirely consistent with the equitable nature of the doctrine to disallow interposition of the protection of limited liability. To do so otherwise would be tantamount to constructive fraud. In instances in which the defendant's conduct is fraudulent, as where he has diverted corporate assets to his personal use, or is illegal or violative of public policy, the reasons are even more cogent for preventing the separate entity from defeating reasonably aroused expectations in the creditor and frustrating or contradicting

104. Cataldo, *supra* note 65, at 476.

105. State corporation statutes are intended to afford business creditors some protection. Garrett, *Capital and Surplus Under the New Corporation Statutes*, 23 LAW & CONTEMP. PROB. 239 (1958). But a business creditor also may rely on other factors in dealing with a company such as its general reputation, ratings by credit agencies, its top echelon executives and previous transactions.

the otherwise legitimate policy basis of limited liability. The judicial standards utilized regarding contract creditors ought to reflect their reliance on corporateness or victimization as the result of deception implying the nonexistence of a company.

Cursory examination would suggest tort claimants should stand on a different footing when compared to contract creditors in this area.[106] Yet the analysis of the courts faced with the "piercing" question scarcely seems to recognize the validity of this difference.[107] Tort liability, in contrast to a contractual obligation, usually arises from a nonconsensual transaction in which the party harmed does not rely on the presence or absence of the corporate form or assets or the lack of indicia of corporateness. Indeed, the corporation, management and shareholders are probably unknown to the tort claimant. Furthermore, unbeknownst to the tort claimant the principal reason for incorporation may have been to escape the very risks the claimant represents. Unlike the case of the contract creditor the court should not consider the absence of any relationship between the corporation and injured party. But as noted in *Zubik*:

> The corporate form itself works no fraud on a person harmed in an accident who has never elected to deal with the corporation.
>
> . . . .
>
> Nowhere does it appear that anyone failed to insure or felt protected in reliance upon Zubik Corporation's assets.[108]

From the previous discussion of standards for disregarding corporateness it should appear a court may be eclectic and flexible in its approach if it chooses. If so what should its approach be toward tort claimants?

When dealing with a tort claimant it seems fatuous for the court to dwell at any length on the legitimacy of organizing to achieve insulation or whether or not the corporate rites have been scrupulously followed, especially respecting close corporations.[109] Otherwise such rigid adherence to formalities might spell unbreach-

106. *See e.g.,* Comment, *supra* note 81, at 134-40; Note, *supra* note 60, at 1192-96.

107. *Compare* Walkovszky v. Carlton, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966) *with* Zubik v. Zubik & Sons, Inc., *supra* note 75. *See* N. LATTIN, R. JENNINGS and R. BUXBAUM, *supra* note 8, at 156-57.

108. Zubik v. Zubik & Sons, Inc., *supra* note 75, at 273-74. This language seems incongruous with the court's reasoning that the corporate veil may be "pierced" where the business was formed with the specific intent to escape specific torts. Conceivably incorporation for the sole purpose of avoiding personal liability arising from a prospective tort or contract claim could be said to work a fraud on the claimant before he has any contact with the company. *See* the discussion *supra* note 76.

109. As noted, statutory recognition of the privilege of limited liability and the onerous burden of establishing the prime motivation make such an inquiry impractical. Further, nonobservance of corporate formalities may be condoned as an insufficient ground for "piercing." *E.g.,* Contractors Heating and Supply Co. v. Scherb, 432 P.2d 237 (Colo. 1967); Galler v. Galler, 32 Ill.2d 16, 203 N.E.2d 577 (1964).

able limited liability on the part of shareholders for corporate torts. This is inconsistent with the equitable objectives of the "piercing" rationale and fails to acknowledge that the claimant is adventitiously related to the tortfeasor corporation. If it is possible to devise different standards for the tort claimant, account must be taken of the difficult evidentiary problems confronting him. For example, requiring proof that the business in reality operates as a partnership is obviously burdensome to the party concerned only with adequate compensation. Indeed such a burden might surpass that of the contract creditor which could involve merely a single commercial transaction.[110] It might also be argued that it is irrelevant whether the defendant shareholder or parent company dominated the wrongdoer corporation or intermixed his affairs with the company's because the tort claimant neither knows nor relies on these matters.[111] While these factors may not be the proximate cause of the claimant's loss or injury they probably will remain relevant considerations because such pervasive control denotes a measure of responsibility for the concern's actions.[112] Perhaps a judicial approach which minimizes the tort claimant's burden of proof in "piercing" the corporate veil and maximizes realization of the compensatory, deterrent, and punitive goals of tort liability should be developed.[113] This makes some sense if one is prepared to accept the premise tort losses are a normal business risk and denying limited liability is the most effective means of spreading and absorbing the individual's damage. Depending on one's value system or order of social priorities it is also arguable that the tort claimant should receive more sympathetic treatment than the contract creditor. This implies an easier, more accommodating approach in disregarding corporateness on the part of courts.

The fact of inadequate corporate resources to redress tort victims would seem to suggest that undercapitalization is the most important factor in regard to tort claimants (if not for creditors generally).[114] Recent tort-piercing cases tend to reinforce this impression.[115] The growing significance of this factor would obtain whether the tort was attributable to a close corporation or a subsidiary company. As noted, three formidable barriers generally

110. Note, *supra* note 60, at 1193.

111. Comment, *supra* note 81, at 136.

112. 1 F. O'NEAL, *supra* note 78, at 32, n. 72.06 (Supp. 1968).

113. *See* note, *supra* note 60, at 1195. Courts will be reluctant to implement this proposition. Mull v. Colt Co., 31 F.R.D. 154, 166 (S.D.N.Y. 1962).

114. This is hardly an original conclusion but it has received urgent emphasis in recent literature on "piercing." Comment, *supra* note 81, at 138-41; Note, *supra* note 60, at 1193-94.

115. *E.g.*, Mull v. Colt Co., 31 F.R.D. 154 (S.D.N.Y. 1962); Minton v. Cavaney, 56 Cal.2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961). 1 F. O'NEAL, *supra* note 78, at 32, n. 72.09 (Supp. 1968). These cases all involve close corporations.

exist to the predominance of this factor in the "piercing" cases.[116] Some courts have not explored it as a factor at all while others treat it only lightly. As a factor, undercapitalization is just that and no more. Courts consider it, some perhaps more heavily than other elements, but do not appear prepared to regard it as dispositive of the question of accountability for a particular type of claim.[117] Definitional problems permeate the concept of undercapitalization.[118] Corporation enabling statutes offer no guideposts so courts are left to their own devices. Does sufficient capitalization relate to the portion of assets constituting shareholder equity or include corporate assets in their entirety?[119] The requisite amount of financial resources should fluctuate according to the scope and nature of the corporation's business activities and its predictable adverse impact on the general public.[120] Most courts are probably prone to judge the adequacy of a particular corporation's capital structure largely on the basis of its present and foreseeable *business purposes and activities*. This may not be the same as evaluating capitalization from the viewpoint of the potential risks to the public resulting from the corporation's activities. An expanded judicial vision of adequate capitalization is required.[121]

Inextricably linked to the question of adequate capitalization is the extent of control and prudence exercised in managing the affairs of the corporation, particularly close corporations, by the affected shareholders.[122] Personal liability will not, and should not, flow merely on the ground that an internal management structure re-

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116. *See* Comment, *supra* note 81 at 138-41; Note, *supra* note 60, at 1193-94.

117. Mull v. Colt Co., 31 F.R.D. 154 (S.D.N.Y. 1962). What is more surprising is that no commentator expressly proposes, especially in tort cases, that inadequate capitalization be held a substantive ground for "piercing." Perhaps this is unworkable in the absence of agreement on what adequate capitalization should mean. An argument can certainly be made for the need for legislative action to fill the void.

118. N. LATTIN, R. JENNINGS and R. BUXBAUM, *supra* note 8, at 152-53.

119. Note, *supra* note 60, at 1194 and cases cited therein.

120. This seems to be the view in Mull v. Colt Co., 31 F.R.D. 154 (S.D.N.Y. 1962) where the Court measures the adequacy of capitalization in terms of the business' "prospective liabilities" and the "public responsibility inherent in its very nature." The latter point seems to emphasize the potential hazards to other parties arising from the character of the operations of the business.

121. Comment, *supra* note 81, at 138-41 declares that the notion of adequate capitalization must cover possible tort victims. The writer would require the tort claimant to show that the shareholder "so dominated his corporation as to make it his instrument" and that capitalization is inadequate by the standard enunciated in Walkovszky v. Carlton, 18 N.Y.2d 414, 426, 223 N.E.2d 6, 13, 276 N.Y.S.2d 585, 594 (1966). (Keating, J. dissenting). Two criticisms may be directed at this test. The term "dominance" seems to exclude other shareholders who may participate in close corporation decisions. What happens if a single shareholder does not control the business? The label "instrument" is unhelpful. Possibly dominance ought to mean shareholder-officers who are responsible for "the operational policies giving rise to the tort" and who fail to "accumulate sufficient assets or insurance to satisfy the tort judgment." *See* Note, *supra* note 60, at 1195. Judge Keating's statement that a corporation "vested with a public interest" must possess resources commensurate with liabilities rising in the ordinary course of business adds confusion, rather than clarity, in assessing the adequacy of a business' assets. There can be no disagreement, however, that adequacy of capitalization is to be judged at the time of the wrong. Comment, *id.* at 139.

122. Tennery, *supra* note 54; Note, *supra* note 60, at 1195. *See also* 1 F. O'NEAL, *supra* note 78, at 31-32.

sembling that of a partnership exists. However, the ability under the newer close corporation statutes to transfer management control and authority to the participants would seem to increase the prospect of attributing the tort directly to their carelessness and neglect in managing the concern. As far as the close corporation is concerned it is arguable courts should respond to this new power of members to direct the course of the corporation by imposing a more stringent precondition to preserve limited liability in the form of a higher duty of diligence in planning, capitalizing, managing, and securing risk spreading devices.

Contemporary legal standards for disregarding corporateness are often deficient in failing to distinguish the different interests and problems of tort creditors and contract creditors. But designing new judicial criteria to protect the legitimate interests of each type of claimant is not an easy task. The reconciliation of the claimant's interests with the premises and statutory policy supporting limited liability is a major obstacle. If one assumes that the privilege of limited liability for shareholders must yield to creditors otherwise forced to carry unanticipated losses, then the courts will have to readjust their thinking, especially in relation to close corporations. The twin concepts of the separate corporate entity and limited liability must be critically re-examined and presumably deemed less sacrosanct by the courts. This reassessment is made the more difficult by uncertainty concerning its economic consequences. Even should courts be unwilling to do this they surely can revise their view on capitalization so as to measure its adequacy in terms of actual and potential liabilities to the public rather than merely the corporation's business needs.

C. The Subordination of Creditor's Claim Rationale

In an effort to ascertain whether or not contemporary judicial tests for disregarding corporateness can be clarified, improved upon, or superseded by borrowing from other corporate law sources it is necessary to examine an allied area; that of reorganization, receivership, or bankruptcy proceedings in which the corporate creditor strives to prevent a parent corporation or dominant shareholder or executive from participating on a parity with him in the insolvent concern's assets on the ground it would be inequitable to do so.[123] Here the converse of the piercing situation is involved—no attempt is made to judicially negate limited liability. This subordination of claims process, based on the unfairness surrounding the creation of an authentic claim or the finding that the indebtedness

123. R. STEVENS and H. HENN, *supra* note 8, at 394 articulate this as a possible approach.

is fictitious or a sham, is known to most as the *Deep Rock* doctrine, but that phrase will not be used now because of the professional wrath it has produced and its legal quiescence in recent years.[124]

The equitable practice of subordinating "inside" creditors' claims has been applied to single companies and the parent-subsidiary relation. The subordination principle was first applied in a parent-subsidiary context by the United States Supreme Court to a corporate reorganization under the Bankruptcy Act.[125] The Court declared:

> Petitioners invoke the so-called instrumentality rule,—under which, they say, Deep Rock is to be regarded as a department or agent of Standard,—to preclude the allowance of Standard's claim in any amount. The rule . . . is not, properly speaking, a rule, *but a convenient way of designating the application in particular circumstances of the broader equitable principle that the doctrine of corporate entity, recognized generally and for most purposes, will not be regarded when so to do would work fraud or injustice.*[126]

In the same year the Supreme Court applied the principle to the claim of a controlling shareholder in *Pepper v. Litton,* noting that, as a bankruptcy court, the federal district court's equitable powers included the rejection of claims in whole or in part "according to the equities of the case."[127] The Court observed

> [T]hat equitable power also exists in passing on claims by an officer, director, or stockholder. . . . [D]isallowance or subordination may be necessitated by certain cardinal principles of equity jurisprudence. . . . [T]he entire community of interests in the corporation [is involved]—creditors as well as stockholders. . . .
>
> In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice and unfairness is not done. . . .[128]

Later came the Court's most significant language:

> But in that situation [when the order of payment of claims was not in question but disallowance of a claim as a fabrication by holding the debtor concern the stockholder's own enterprise, consistently with the course of conduct of the stockholder] as well as in the others . . . a sufficient

124. Stroia, *Deep Rock—A Post Mortem,* 34 U. DET. L.J. 279 (1957).
125. Taylor v. Standard Gas Co., 306 U.S. 307 (1939).
126. *Id.* at 322 (emphasis added).
127. 308 U.S. 295, 304 (1939).
128. Pepper v. Litton, 308 U.S. 295, 306-08.

> consideration may be simply the violation of rules of fair play and good conscience. . . . He [a corporate fiduciary] cannot by the use of the corporate device avail himself of privileges normally permitted outsiders in a race of creditors. . . . He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power . . . to the detriment of . . . creditors no matter how absolute . . . and no matter how meticulous he is to satisfy technical requirements.[129]

A close reading of these two cases does not disclose whether the court simply embellished the "piercing" doctrine or replaced it with a new, flexible tool of equity. Henn seems to conclude that the upshot of the subordination cases is to cancel the use of an "instrumentality" doctrine and substitute a "new standard based upon fairness and the equities of the case."[130] The main advantage of shifting to a "fundamental fairness" approach presumably is to avoid a possible judicial "hang up" with the separate entity concept and to permit the court to focus primarily on competing interests without being sidetracked by matters of form.

Henn's statement compels one to ask whether or not he properly construed the cases, and, if so, whether the principle, as stated, is a workable substitute for or at all helpful in illuminating the "piercing" doctrine as now conceived. The scope and meaning of the principle of subordinating debt claims certainly cannot be gleaned from the two Supreme Court decisions, one of which involved a parent which misused a subsidiary for its own enrichment (the instrumentality idea) and the other which involved a shareholder-officer who violated his fiduciary duty in dealing with the company (thus freighting a bankruptcy case with even greater equitable considerations). However, the language of the Court in *Pepper v. Litton* and the fact a federal bankruptcy court sits as a court of equity indirectly support Henn's position. Yet distortion can only be averted if the favored treatment usually accorded creditors is remembered. Israels tentatively read the doctrine as requiring inadequate capital from the outset and mismanagement or management for personal advantage or interest.[131] More importantly the doctrine failed to indicate "what the extent of the duty to provide adequate capital may be."[132] Israels speaks in terms of a doctrine which arose from an "exploitive" situation but is uncertain whether or not it is "a new remedy for a recognized fact pattern"

129. *Id.* at 310-11.
130. H. HENN, *supra* note 6, at 212. Reference to "instrumentality," if useful at all, should pertain only to the parent-subsidiary relation.
131. Israels, *The Implications of the "Deep Rock" Doctrine*, 42 COLUM. L. REV. 376, 379 (1942).
132. *Id.* at 388.

or a "new substantive right."[133] Even his multi-factor analysis does not yield a definitive answer except to underscore the interrelation of adequate capital and protection of the public interest. On the other hand, the doctrine has been called "one of the milestones of parent-subsidiary law."[134] But this description of the scope of the doctrine's applicability is too narrow. It resembles the "piercing" cases in that the problem in both takes the form, albeit not identical, of competition for corporate assets. In both situations, on the basis of the equities of each case, "insiders" seek to maintain a favored position to the detriment of outside creditors. Outside interests prevail only when the "insider's" actions are contrary to established equitable principles.

One writer properly considers the doctrine of equitable subordination of claims as a multi-factor problem requiring appraisal of such matters as inadequate financing, the siphoning off of corporate resources, a general predisposition to ignore the interests of creditors and stockholders and various degrees of corporate mismanagement.[135] This is of course similar to the current approach of courts in disregarding corporateness. It is suggested that inadequate capitalization is "of itself, sufficient to warrant subordination" whether it is present at the inception of corporate life or arises thereafter because of management's decision to expand without enough equity financing.[136] Both situations "require analysis of venture capital needs of comparable soundly financed organizations." The proposition is offered that subordination of a claim may occur in the absence of evidence of mismanagement, a position of considerable logic in light of the informal operations of close corporations, when the company lacks adequate security to protect outside creditors. *Arnold v. Phillips* illustrates this point where a creditor's obligation was construed in equity to be venture capital because it had been advanced in the face of foreseeable financial adversity.[137] The impact of this case cannot be overlooked in determining whether to preserve limited liability.

> The ruling indicates that 'advances' at the inception of a business may be subordinated, even in the absence of other types of mismanagement. It also throws light on the extremely difficult question of when a loan made by a dominant stockholder to a business in financial difficulties will be permitted to retain its normal status.

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133. Israels, *supra* note 131, at 393.

134. Krotinger, *The "Deep Rock" Doctrine: A Realistic Approach to Parent-Subsidiary Law,* 42 COLUM. L. REV. 1124 (1942).

135. *Id.* at 1129-38, *See* Sprecher, *The Conflict of Equities Under the "Deep Rock" Doctrine,* 43 COLUM. L. REV. 337, 342-51 (1943).

136. Krotinger, *supra* note 134, at 1129.

137. 117 F.2d 497 (5th Cir. 1941), *cert. denied,* 313 U.S. 583 (1941).

> A fortiori an advance to an adequately capitalized business made when insolvency is not threatened will, if made for proper business purposes, be sustained.[138]

The value of this analysis in "piercing" cases is manifest. Shareholder loans to a corporation made promptly after incorporation may be thought to presumptively show that the original capitalization was defective which in turn demonstrates a want of business planning.[139] Additionally, the equitable subordination cases establish the primacy of inadequate capitalization as a basis for selecting among conflicting interests in an area where the public interest—protection of creditors—has generally been deemed paramount. This should reaffirm the crucial nature of this factor in disregarding corporateness.

Unfortunately the equitable subordination litigation does not appear to help crystalize the doctrine of disregarding corporateness to any discernible extent despite the equitable basis and common components of both doctrines. However, resolution of the questions arising under both doctrines naturally requires general, vague equitable formula and multiple element analysis. The counterpart to *Zubik's* formulation was well expressed in *Costello v. Fazio*:

> As stated . . . the question to be determined when the plan or transaction which gives rise to a claim is challenged as inequitable is 'whether within the bounds of reason and fairness, such a plan can be justified.'
>
> Where . . . the claims are filed by persons standing in a fiduciary relationship to the corporation, another test which equity will apply is 'whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain.'[140]

The fiduciary relation test is inapposite in disregarding corporateness. The fairness standard, if it can actually be termed a test, parallels the imprecision and unpredictability of the "piercing" approach. In spite of these flaws, the subordination fairness test avoids the confusion of the "mists of metaphor," the entity hurdle, and considers largely the equities and substance of each case. Avoidance of the niceties of form to achieve justice is the principal lesson for courts to learn in borrowing from the subordination cases in order to improve their approach to disregarding corporateness.

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138. Krotinger, *supra* note 134, at 1131.

139. *See*, Semmel, *Tax Consequences of Inadequate Capitalization*, 48 COLUM. L. REV. 202, 214-15 (1948).

140. 256 F.2d 903, 910 (9th Cir. 1958).

IV. THE LEGISLATIVE ROLE IN DISREGARDING CORPORATENESS

It is perhaps thought that legislative policy concerning the limited liability of shareholders is already so well defined and settled that no further action is necessary. Indeed no change in this area is contemplated by the draftsman of the Model Business Corporation Act nor were any revisions initiated in the new enactments pertaining to close corporations.[141] However, it has been urged that the present state of affairs is dangerous to the public, especially where close corporation operations are concerned.[142] Criticism of this sort requires a brief examination of the philosophy and structure of twentieth century corporation statutes. Professor Katz concludes that current corporation acts reflect

> an 'enabling act' theory, more or less modified by the theory that corporation statutes, while assuring freedom of contract, should reinforce in various ways the responsibility of individual decisions; and the theory that freedom of the parties should be limited in order that the results of responsible freedom may more nearly be approximated.[143]

The elements of the enabling act theory include free availability of incorporation and limited liability, promoter's freedom in defining the scope of the corporation and its security structure, and "relatively unhampered procedures" to accommodate "changing conditions by effecting changes in corporate purposes and security structures."[144] Moreover, most statutes following the enabling act philosophy no longer embrace the idea of a "capital fund, or margin of safety, for creditors as a substitute for the personal liability of shareholders." Such statutes also authorize formal, and occasionally informal, reductions of capital without safeguarding existing shareholders. The result is that creditors must "make their own bargains for the limitation of their risk."[145] Corporate statutes seek to avoid being unduly restrictive despite a wide divergence of professional opinion concerning their appropriate objectives. Although acknowledging some recent notable improvements in state regula-

141. Scott, *Changes in the Model Business Corporation Act,* 24 BUS. LAW 291 (1968). In terms of shareholder liability the issues with continuing vitality include liability for "watered, bonus, or discount" shares which are unlawfully issued, whether legally qualified consideration is given for shares and whether property exchanged for shares has been overvalued.

142. Note, *supra* note 60. *See also* Winer, *Proposing A New York "Close Corporation Law",* 28 CORNELL L.Q. 313, 314 (1943) ("[B]ecause of the limited assets at risk, the state has the same interest in protecting those who trade with a close corporation as with a public corporation, and the same interest in their tort victims. The assets must not be distributed or dissipated at at expense of the third parties").

143. Katz, *The Philosophy of Midcentury Corporation Statutes,* 23 LAW & CONTEMP. PROB. 177, 187-88 (1958). The new Delaware General Corporation Statute epitomizes this philosophy.

144. *Id.* at 179.

145. *Id.* at 181-83.

tion of corporations, Professor Jennings correctly observes "incorporation statutes of the more 'liberal' states are essentially enabling acts, which contain many loopholes for an irresponsible management and a minimum of protective provisions in the interest of shareholders."[146]

The trend in corporation statutes described by Katz and Jennings has not been arrested. After an extensive survey of changes in corporation statutes between 1959 and 1966, Professor Folk found a "negative development"—"state statutes are obviously becoming increasingly lax as they give management more and more leeway in handling corporate affairs."[147] A more alarming development to some concerned with protecting parties outside the corporation is the fact:

> The Model Act, typifying most newer statutes, makes no advance in protecting creditors, and, indeed it is doubtful that this should be a proper function of the incorporation provisions. Most statutes require only nominal capital, if any at all, and exact only a liability to pay the unpaid portion of this minimum capital . . . a corporation may start doing business with a one dollar capitalization. . . . Whether or not this will induce courts to extend the common law authority subjecting an insider to personal liability will depend largely upon whether courts read the statutorily required minimum capital as abrogating any common law liabilities.
>
> The problem is one which corporate law revisers have given up on, hoping that commercial practice, availability of information, and creditor self interest will take up the slack.[148]

Under the statutory conditions posited by Folk, only a contract creditor, but not a tort claimant, of the corporation could expect to be sufficiently enlightened to protect his interests.

This enabling act spirit pervades both the general corporation statutes under which publicly held corporations operate and to a greater extent the special legislation designed for close corporations. Minimum legislative restraints on how management should conduct the business characterize both statutes,[149] but only under the special close corporation provisions are the owners authorized to approximate complete permissiveness.[150] Even though most corpor-

146. Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 LAW & CONTEMP. PROB. 193, 194 (1950).
147. Folk, *supra* note 58, at 281.
148. Folk, *supra* note 58, at 122-23. *See also* ABA-ALI MODEL BUS. CORP. ACT. ANN. § 51, para. 2.02(2) (1960).
149. *See* note 69 *supra* for a discussion of the shaping of new judicial controls over public companies.
150. Statutory permissiveness is complemented by judicial concessions. Galler v. Galler, 32 Ill.2d 16, 203 N.E.2d 577 (1964). *But see* a concerned discussion of this case in Elson,

ate specialists doubtless approve of partnership flexibility for the close-corporation the sharp dissent registered to the nonregulatory legislative current is thought provoking.

A student writer has raised the question in terms of shareholder responsibility for corporate torts stating: "Corporations owned by affluent shareholders, yet too impoverished to meet their tort liabilities, are the inevitable product of present day incorporation laws."[151] Supported by certain recent egregious decisions,[152] it is argued that corporation acts encourage financial irresponsibility, or worse, by granting limited liability to shareholders in the smaller enterprises.[153] This point is hardly novel for a traditional purpose of incorporation has been to evade accountability for all business debts including tort liability. Yet difficult questions are raised concerning the efficacy of existing corporate legislation and legal doctrine in protecting the interests of creditors. A creditor, least of all the tort creditor, cannot safely anticipate that the enterprise will have adequate capital to cover its reasonable liabilities, given the nominal or minimum capital requirements of corporation statutes.[154] Provisions in corporate enabling statutes generally prohibit the creditor from reaching the shareholder directly for any loss or injury, unless the shareholder happens to act in a management capacity too.[155] It is also argued the alternative rationale under the "piercing" doctrine fail to afford tort creditors adequate protection.[156] It cannot be categorically stated close corporation shareholders are virtually immune from tort claims if the entity is properly maintained (whatever that may mean),[157] but it is perhaps true shareholder-managers in the close corporation, through their operational

Shareholder Agreements, A Shield for Minority Shareholders of Close Corporation, 22 BUS. LAW. 449 (1967).

151. Note, *supra* note 60 at 1190-91.

152. *E.g.,* Walkovszky v. Carlton, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966). *See* Note, *supra* note 60, at 1190, n. 1 for an indication of the serious losses suffered by an unsuccessful tort claimant.

153. Note, *supra* note 60, at 1191 singles out shareholders in taxicab, real estate, entertainment, shipping and manufacturing concerns as unwelcomed beneficiaries of this protection from tort liability. To these might be added new businesses being formed under the "black capitalism" program in ghetto areas, small construction firms, and private and nonprofit urban redevelopment corporations engaging in land acquisition, slum clearance, rehabilitation, and housing construction. *See, An Act to Establish a Corporation for Urban Development,* 5 HARV. J. LEGIS. 529 (1968); Lesher, *The Non-Profit Corporation—A Neglected Stepchild Comes of Age,* 22 BUS. LAW. 951 (1967); Note, *The Legal Framework Governing Operation of Modern Nonprofit Corporations,* 47 IA. L. REV. 1064 (1962) (criticizing outmoded state statutes).

154. *Supra* note 148.

155. *See* the statutes cited *supra* note 59.

156. Note, *supra* note 60. It is charged imposing personal liability when individual and corporate assets are mixed or a misrepresentation is made applies only to contract claimants. Undercapitalization is both misunderstood and merely a single factor in "piercing" cases. Non-observance of corporate formalities as a ground for "piercing" is a mockery because of the ease of compliance with the statute and the difficulties in proving deviations therefrom.

157. *E.g.,* Thoni Trucking Co. v. Foster, 243 F.2d 570 (6th Cir. 1957); Minton v. Cavaney, 56 Cal.2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961); Allen v. Morris Bldg. Co., 360 Mich. 214, 103 N.W.2d 491 (1960).

control, have a clearer responsibility to furnish adequate assets or insurance coverage.[158] The privilege of limited liability must be balanced with the ends of tort law as well as contract law, but it might be that sufficient assets to cover corporate debts could be assured if undercapitalization was understood and properly weighed by the courts in "piercing" cases.

Despite the fact empiric evidence does not conclusively establish the need for legislative intervention on behalf of creditors, just such a solution is proposed.[159] The statutory solution, which has been proposed to protect tort creditors and apply only to close corporations because of their peculiar nature, could take one of two forms. The first approach would require imposing personal liability on shareholders, should the claim exceed corporate assets, which effectively "pierces" the veil without involving problems of legal doctrine.[160] This requirement is not harsh for the shareholders could readily purchase insurance or set up reserves to meet such obligations. Arguably such a statutory requirement also removes the potential disincentive in existing statutes to plan the business carefully. The alternative approach, compulsory liability insurance for close corporations, does not seem any more burdensome.[161] Most businesses today find it essential to purchase casualty or liability insurance and the cost is unlikely to be prohibitive.[162] The

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158. *See* Note, *supra* note 60, at 1193.

159. Note, *supra* note 60, at 1198-1201. Legislative action would diminish the expense, time and anguish involved in bringing damage suits based on the "piercing" doctrine.

160. Note, *supra* note 60, at 1201, n. 44. The scope of the statute would be restricted to concerns whose common stock is not owned "by or for not more than twenty-five persons, not counting those who own stock representing neither one per cent or more of the outstanding common stock nor more than a book value of $10,000." The proposed statute, reflecting a distinction made by courts on some "piercing" cases, would preserve limited liability for shareholders lacking significant power over the close corporation's affairs and hold personally liable its active managers (officers and directors), influential shareholders (owning more than ten per cent of the concern's outstanding stock), and any senior security holder exercising authority over the firm. *Id.* at 1199, n. 40. Several questions are immediately raised. Why a limitation to only 25 shareholders? *See* DEL. CODE ANN. tit. 8 § 342 (a)(1) (1967) (record shareholders of close corporations cannot exceed thirty). Why exclude contract creditors from the protection of the statute if the courts make such tortuous use of the "piercing" doctrine? In imposing personal liability for corporate torts on those owning securities "for other than investment purposes", is a standard created which actually facilitates the court's task? What if a shareholder owns considerably more than ten per cent of the firm's outstanding stock (thus presumably not for investment reasons) but does not directly involve himself in its business affairs? Is this sufficient to immunize him or does he still have a duty to appoint or hire competent personnel and assure prudent operations? What is an active participant "in management of the enterprise"? How is the proposed statute affected by the new close corporation statutory provisions *supra* note 59? The suggested statute does provide for a scheme of contribution among affected security owners. *Id.* at 1201 n. 44.

161. Note, *supra* note 60 at 1201-03. But problems admittedly exist. Such regulation will mean increased administrative costs for the state. Different types of small enterprises requiring different insurance coverage make an orderly approach difficult. An alternative to insurance—a "declaration of realizable assets"—is also recommended. *Id.* at 1203. But is this a substantial improvement over granting the Secretary of State or State Corporations Commissioner authority to determine in each case whether the corporation starts business with adequate resources (with some provision for systematic, periodic re-evaluation in the light of current business) or insisting courts merely give greater weight to under-capitalization in applying the "piercing" doctrine? *Compare* Sterling, *California Securities Law of 1968: Underwritings and Corporate Reorganizations*, 23 BUS. LAW. 645, 647 (1968).

162. Note, *supra* note 60 at 1203-04 states six reasons for preferring the imposition of

proposed statutory solution is bottomed on two assumptions which seem open to serious dispute. It is by no means clear that the alternative approaches to "piercing" the corporate veil are inadequate if properly applied.[163] The fault conceivably lies in the failure of courts to comprehend the importance and meaning of undercapitalization and the need to balance equities more than pay respect to the separate entity idea. The passage of time has established the need for special legislation for close corporations, but the same cannot be said of the proposed solution. To justify such legislation it is necessary to define the problem's dimensions by something other than recitation of several poorly reasoned cases. However, if Dean Tennery's evaluation of the manipulative and risk transference potential of close corporations is accurate it is possible additional legislative restrictions may be in order to protect creditors. The proposed statutory solution is not unprecedented in view of the provisions in state constitutions and corporation enabling acts imposing liability on shareholders beyond their equity investment. Yet considering the recent legislative attempts to facilitate organization of close corporations it is unrealistic to anticipate widespread acceptance of proposed provisions which might actually discourage formation of close corporations.

The concern over creditors which generated the proposed statutory solution is counterbalanced by a fear the new close corporation statutes will induce courts to more readily impose personal liability on shareholders.[164] This belief is premised on the notion the elimination of traditional corporate formalities from these statutes renders close corporations more vulnerable to attack under the "piercing" doctrine. Evidence to substantiate this danger is hard to discover and long standing judicial approval of informal management practices in close corporations seems to militate against it. Nevertheless, Professor Bradley has suggested a statute to insure judicial respect for the limited liability principle.[165] His proposed statute would link the entity concept and limited liability privilege and leave them unaffected by the presence of control agreements or stock transfer restrictions endemic to close corporations. Persons "voluntarily" dealing with the corporation would be confined to its assets in satisfying claims in the absence of "actual fraud." Even

personal liability pursuant to a statute. But the insurance needs of corporations are growing in proportion to their new amenability to liability. *See* Note, *Liability Insurance for Corporate Executives*, 80 HARV. L. REV. 648, 651 n. 21 (1967) (directors' and officers' liability insurance is expensive).

163. *See* Comment, *supra* note 81; Comment, *Corporations: Preserving the Separate Entity of the Oklahoma Close Corporation*, 21 OKLA. L. REV. 205 (1968). Further, the leading writers *supra* note 6 are not generally critical of the prevailing formulation and use of the doctrine.

164. Bradley, *A Comparative Evaluation of the Delaware and Maryland Close Corporation Statutes*, 1968 DUKE L.J. 525, 553-54.

165. *Id.* at 554.

if there is a legitimate basis for Professor Bradley's fear of increased close corporation shareholder liability it is doubtful that his statute would prevent courts from refusing recognition to limited liability.

There is agreement in principle that the limited liability of shareholders is not absolute and that creditors may, in exceptional cases, reach beyond corporate assets. There is also agreement that the immediate problem relates to close corporations. But at this point disagreement exists—one statute is proposed to help tort creditors overcome limited liability and another is suggested to sustain the privilege against judicial onslaught. Professor Bradley abhors "literal enforcement" of a "capital corresponding to reasonable contingencies" test, but seems to ignore tort claimants:

> Creditors, of course, are free to negotiate the terms . . . with the corporation. Thus, if a question exists as to the probable success of the venture, the creditors should insist upon an appropriate security . . . or . . . a personal guarantee from shareholders. Because of this contractual freedom and the opportunity for prior investigation into the stability of the enterprise, creditors should not be entitled to a judicial inquiry into the "reasonableness" of the capitalization. . . . While creditors deserve protection against deception and unfair dealing, they are risk-takers in much the same sense as shareholders. . . .[166]

Qualifying the limited liability of shareholders on the basis of equitable considerations certainly requires differentiating among creditors' claims and makes systematic statutory treatment of the problem difficult, if not impossible. Statutes may prove to be ameliorative and indeed a partial answer to some of the problems that are anticipated will arise from the distinct nature of the close corporation, but it is doubtful whether any statute can provide a definitive and comprehensive solution to these problems. Therefore, proponents of specific statutory solutions must recognize that at the most the "piercing" doctrine may only be modified.

V. CONCLUSION

Over a period of time legitimate dissatisfaction is often expressed with the formulation, or more likely, the application of a judicially developed doctrine and its results. The principal charge is usually that the judicial doctrine is not sufficiently relevant to new and constantly changing needs and conditions. This also seems to be the overriding concern with the "piercing" doctrine in relation to the close corporation which is gradually assuming almost full

166. *Id.* at 554.

partnership procedural trappings. One view is that the contemporary "piercing" doctrine affords little or no protection to those who may sustain injury or loss from a close corporation's activities. A diametrically opposed view asserts that the doctrine has been applied excessively so as to frustrate use of the close corporation form of doing business. Both views may raise genuine problems under the "piercing" doctrine, but the evidence marshalled to date makes it exceedingly difficult to establish the urgency of one over the other. Implicit in this divergence of opinions, however, is the perception that separate legislative and judicial treatment of the close corporation has not included an appreciation of the potential problems that may arise from permissive management practices.

Reservations about the pertinency of the "piercing" doctrine relative to the problems peculiar to the close corporation never seem to recognize that courts have successfully dealt with the problems of partnerships for a long time. This experience should be of some value as close corporations steadily acquire a more independent legal status. It is a harsh, and perhaps unwarranted, judgment to write of the "long-discredited 'tests' for 'piercing the corporate veil' " which are "too numerous and irrational."[167] One simply cannot ignore the fact that courts do, and will continue, to use equitable formulas and consider multiple factors in disregarding corporateness. The "piercing" doctrine is resilient and therefore able to adapt to new situations. Further, legislatures have shown no disposition over the years to tamper with a doctrine that does not appear to have perceptibly impeded the formation of corporations. Thus, it is more plausible to discuss the doctrine as "a sensible weighing of all the facts [which] indicates a real abuse or perversion of the corporate privilege."[168] Concedely, in this difficult area, the courts cannot offer exactitude in terms of appropriate standards for disregarding corporateness—hardly an anamoly in our legal system. Rationality in the judicial process is achieved only by the careful sifting of the facts, equities and competing interests of the parties in each case to accomplish particularized justice. Since the likelihood of legislative restriction or modification of the "piercing" doctrine is scant, its critics ought to concentrate on improving the doctrine itself. If any major criticism can be leveled at courts using the doctrine, it is that they have sometimes disengaged from the tough balancing process required and fallen back on technical considerations and form.[169] In the long run, better

167. *Id.* at 553.

168. *Id.* at 554.

169. *See e.g.,* Hellenic Lines Ltd. v. Winkler, 249 F. Supp. 771 (S.D. N.Y. 1966); Alfred P. Sloan Foundation Inc. v. Atlas, 42 Misc.2d 603, 248 N.Y.S.2d 524 (Sup. Ct. 1964), *aff'd.* 23 A.D.2d 820, 258 N.Y.S.2d 807 (2d Dept. 1965), as good examples of a bad tendency.

business planning and legal counselling before and after incorporation would be a more substantial contribution to the solution of the problems the "piercing" doctrine is designed to resolve.